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THE STATE OF U.S. RETIREMENT SECURITY: CAN THE MIDDLE CLASS AFFORD TO RETIRE?

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

DISCUSSING THE CURRENT STATE OF RETIREMENT SECURITY, FOCUSING ON THE CHALLENGES FACING ASPIRING RETIREES FOLLOWING THE RECENT FINANCIAL CRISIS AND HOW THE LEVEL OF RETIREMENT SECURITY IMPACTS THE ECONOMY

MARCH 12, 2014

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THE STATE OF U.S. RETIREMENT SECURITY: CAN THE MIDDLE CLASS AFFORD TO RETIRE?

WEDNESDAY, MARCH 12, 2014

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON ECONOMIC POLICY,
Washington, DC.

The Subcommittee met at 3:10 p.m. in room SD–538, Dirksen Senate Office Building, Hon. Jeff Merkley, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR JEFF MERKLEY

Senator MERKLEY. I call this hearing of the Economic Policy Subcommittee of the Committee on Banking, Housing, and Urban Affairs to order.

The American dream is a powerful concept that has driven generations of Americans to strive for a better life. However, the American dream is not limited just to the idea that through hard work and determination an American can obtain a good living wage job and provide for a family.

Not limited to that, it is also very much a part of our dream that hard-working Americans will not have to live in fear of their old age—that hard work, prudent saving, and a strong safety net will allow them to develop a substantial nest egg to support themselves throughout retirement and, possibly, leave something behind for their spouse or children.

Recent reports and projections show that in the decades to come, Washington's actions, particularly concerning Social Security, will have an increasingly profound effect on whether our dream of a secure retirement matches the reality. The ways Americans save for retirement have changed substantially over the past 30 years, including a significant shift from defined benefit plans to defined contribution (DC) plans, which place substantially more risk and responsibility on the individual.

There is also significant evidence that many Americans are unable to adequately save for retirement. At least half of single households did not have any retirement assets in 2010, and the median amount of retirement assets for married households was only about $10,000.

Some of these challenges are a direct result of the great recession, but others are long-term problems exacerbated by the recent crisis. Decades of stagnant wages coupled with suddenly lowered

home values leave working class Americans facing increasingly steep challenges to being able to save adequately. In fact, many young workers find themselves with yet another growing impediment in the form of ballooning student loans.

All of these challenges amplify the importance of Social Security, which today provides, on average, about 40 percent of income for seniors and disabled Americans and creates a safety net for workers and their families. Among seniors who receive Social Security benefits, 23 percent of married couples and about 46 percent of single persons rely on Social Security for the vast bulk of their income—90 percent or more of their income.

Given the current projections, Social Security will, without question, play an enormous role in providing retirement security for Americans. We are fortunate to have joining us today a panel of experts in the economics of retirement security. I hope we can have a robust conversation about the challenges facing American families and how we can enhance U.S. retirement security as a whole.

So thank you very much for coming. I am now going to turn to my colleague, Senator Heller, for an opening statement.

STATEMENT OF SENATOR DEAN HELLER

Senator HELLER. Chairman, thank you, and to our witnesses, thank you for taking time from your busy schedules to be with us today.

Every day American families wonder if they will have enough savings to enjoy a comfortable and stable retirement in the future. As a new generation of Americans prepare to reach retirement age, we are getting a clearer picture of the evolving retirement landscape.

Over the last few decades, new and diversified retirement options have been created in an attempt to increase savings and provide additional retirement income. A growing number of today's workers are preparing for retirement through defined contribution plans like 401(k)s and individual retirement accounts, IRAs, that allow families to accumulate financial assets from investments in stocks, bonds, and mutual funds.

These retirement accounts, along with the development of rules allowing for increased after-tax contribution allowances and ROTH plans, are further expanding individuals' abilities to contribute earnings to their retirement plan. Although these are positive developments, many Americans are still struggling to save for retirement.

The economic downturn and housing crisis have had a particular negative impact on the financial situation of many. In my home State, Nevada, Nevadans are still grappling with one of the highest unemployment rates in the Nation, and for many, their home values are under water. For those individuals who are struggling to get by, retirement is a distant dream.

Until the economy improves, Nevada will remain at a disadvantage when preparing for retirement. In order to combat this crisis, Washington must implement policies that return America's economy back to a period of optimism and growth. The more people that can return to work, the more retirement opportunities will become available to them.

And for that, I want to thank all our witnesses again for attending today's hearing. I look forward to hearing your views on the current state of Americans' retirement security. I hope that our discussion will shed some light on the important issues affecting individuals' ability to financially prepare for their retirement, particularly how current Federal policies are affecting retirement preparedness and what we can do to better prepare all Americans. So thank you. I welcome each of your views as panelists. Thank you, Mr. Chairman, for holding this hearing.

Senator MERKLEY. You bet. And now I will introduce our witnesses. Ted Wheeler is the Treasurer of the State of Oregon. He holds a B.A. from Stanford, a Master's in public policy from Harvard, and an M.B.A. from Columbia. Were there no other colleges left to apply to for other degrees? It is a pleasure to have you travel out from Oregon. Thank you for joining us.

He has served as Treasurer of Oregon since 2010. He has actively pushed for State-level coordination and action in addressing retirement security challenges. In 2013, he advocated for legislation successfully in Oregon that created a State retirement savings task force to consider the trends, current laws, and saving options, and to provide recommendations to the 2015 State Assembly.

He also convened a bipartisan round table of national labor organization representatives, financial industry leaders, and State treasurers to discuss options to help private sector workers without retirement savings plans through their employers. Thank you very much for joining us.

Monique Morrissey has her Ph.D. in economics from American University and B.A. from Swarthmore. She is an Economist at the Economic Policy Institute specializing in retirement security, labor markets, and financial markets. Since joining EPI in 2006, she has focused on a range of issues, including—this is quite a list of things that you have worked on over these years—Social Security, pensions, other employee benefits, household savings, tax expenditures, older workers, public employees unions and collective bargaining, Medicare institutional investors, corporate governance, executive compensation, financial markets, and the Federal Reserve.

She is a member of the National Academy of Social Insurance. Prior to joining EPI, she worked at the AFL–CIO Office of Investment and Financial Market Center. Thank you for joining us today.

Mr. Robert Hiltonsmith is a Policy Analyst at Demos, a public policy think-tank based in New York. He has an M.S. in economics from the New School for Social Research and a B.S. in mathematics and philosophy from Gilford College. He joined Demos in March 2010 to provide research and analysis on issues surrounding retirement security in the United States, with a particular focus on how these issues affected young people.

He has written on a wide variety of topics, including tax policy, fiscal policy, health care, and the labor market. His research has been widely covered in the press, including the Washington Post, Newsweek, Market Watch, Reuters, and Kiplinger. He has appeared on regional and national television and radio, including Fresh Air, Frontline, the Lehrer Show, and Fox Business News. Thank you very much for coming down from New York to join us.

Our next panelist, I know that Senator Elizabeth Warren had hoped to be here in time to introduce you, but she is not able to make it this quickly. We are expecting her in a few minutes, so I am going to go ahead and introduce you.

Kristi Mitchem is Executive Vice President of State Street Global Advisors and head of the Americas Institutional Client Group. She earned her B.A. in political science from Davidson College and M.B.A. from Stanford Graduate School of Business. In this role, she is responsible for the strategic direction and leadership of State Street Global Advisors growing institutional business.

Prior to joining State Street, she worked at BlackRock where she most recently served as Managing Director and head of the U.S. defined contribution business responsible for building with a focus on delivering products for individual 401(k) investors. She has over 17 years of experience in the defined contribution and equities markets.

So with that, we are going to put 5 minutes on the clock for each of you. We will ask you to try to stay within that. There is a little flexibility, but we would like to be able to get through all your remarks and have time to ask some questions and have some dialogue. Mr. Wheeler.

STATEMENT OF TED WHEELER, TREASURER, STATE OF OREGON

Mr. WHEELER. Senators, thank you for having me here. It is an honor. For the record, my name is Ted Wheeler. I am the Treasurer for the State of Oregon. In that capacity, I am responsible for managing the State's $87 billion investment operation, protecting the State's strong credit rating, and providing banking operations to over 1,000 local jurisdictions.

But before I held public office, I worked for a private sector financial management firm that focused predominantly on private sector retirement tools. I was a senior management executive in that capacity.

I want to thank you for shining a light on the critically important issue of retirement security for the middle class. More needs to be done and quickly to reduce the profound economic impact of what I believe is a generational crisis, a crisis that threatens to plunge seniors into poverty, disrupt entire families, and impact the economy on a significant scale.

In Oregon, as across the Nation, a lack of sufficient retirement savings threatens family security and quality of life. What was once considered a matter of personal responsibility is increasingly becoming a public crisis, an economic crisis, whereby people who do not save adequately for retirement then put additional burdens on costly safety net programs, both at the Federal level and at the State level.

Senators, time is not our ally on this matter. In the State of Oregon, our older adult population is expected to double in the next 20 years; and yet, only about half of Oregon's private sector employees have access to retirement planning options at their place of employment. A recent study by AARP–Oregon concluded that one out of every six employees between the age of 45 and 64 in our

State have less than $5,000 in retirement savings. This is a demographic tidal wave which threatens to swamp us.

We all understand that it is hard to save. We understand it is particularly hard for the middle class that has been beset by stagnating wages, escalating costs of higher education, and uncertainty about future costs of health care, among other things.

But what our constituents are telling us and what the data clearly shows is that people are focused on their short-term economic needs and they are not as focused on long-term retirement security options. A huge number of Oregonians are relying predominantly on Social Security for retirement, something for which the program was never intended. In the absence of Social Security in our State, 40 percent of older adults would live in poverty.

In December, I helped to convene a bipartisan round-table of elected State treasurers from across the country. They agreed that retirement security demands America's attention. And next week, as laid out in Oregon's bipartisan legislation, I will convene the first meeting of a new task force that will look at ways that we can incent more retirement savings and potentially expand pooled and professionally managed investment options for Oregon workers.

Among the questions we will attempt to answer: What options are available to bolster the savings of employees who do not have options through their place of employment? What should be the role of the State's successful investment operations, if any? And what options are available to protect the State and private sector employers against liability, pool resources to keep costs low, and that create portable, accessible, and voluntary options for Oregonians?

I think it is appropriate that States are taking on this issue in parallel with your efforts here in Congress. Different States are going to come up with different innovations and different solutions, in large measure based on different expectations about the role of Government. But it is my hope and my expectation that those different ideas and solutions will only contribute to a positive dialogue, much in the same way that the States came together to help the Federal Government pass the 529 tax laws which provided robust savings vehicles for higher education and job training.

In conclusion, I will just remind everybody that this is a bipartisan issue, that it is an urgent issue, and that I want to thank you, in particular, Senator Merkley and Senator Heller, for your focus on an issue of retirement security, retirement security that is moving farther away for many Americans and is out of reach already for some. Thank you for your attention to this.

Senator MERKLEY. Thank you very much. Dr. Morrissey.

STATEMENT OF MONIQUE MORRISSEY, PH.D., ECONOMIST, ECONOMIC POLICY INSTITUTE

Ms. MORRISSEY. Thank you, Chairman Merkley and Ranking Member Heller, for inviting me to testify on the state of retirement security in the United States.

My name is Monique Morrissey. I am an Economist working on retirement issues at the Economic Policy Institute, a nonpartisan think-tank focusing on the needs of low- and middle-income workers.

Retirement security improved significantly in the post-war decades as Social Security expanded and participation in employer-based plans grew. However, the 1980s began a period of retrenchment. Social Security cuts that are still being phased in reduced retirement benefits by almost one-fourth. Meanwhile, private sector employers replaced secure pensions with 401(k) plans, shifting costs and risks onto workers. Though this could have broadened access by making it easier for employers to offer benefits, participation in employer-based plans declined in the new millennium.

Though assets in retirement funds have grown faster than income in the 401(k) era, retirement security worsened as retirement wealth became more unequal and outcomes more uncertain. 40 percent of families approaching retirement have nothing saved in retirement accounts and 10 percent have $12,000 or less. Though the median amount for older families with savings is $100,000, this is not even enough to purchase a $5,000-a-year joint life annuity at 65.

As my co-author and I found in our Retirement Inequality Chart book, a family in the 90th percentile has nearly 100 times more retirement savings than the median family, which has a negligible amount. All told, households in the top fifth of the income distribution account for more than two-thirds of savings in retirement accounts.

There are stark differences by race, ethnicity, and education, as only white households and college graduates are more likely than not to have retirement account savings. An already bad situation was made worse by the collapse of the housing bubble and financial crisis which wiped out $13 trillion in household wealth and left many homeowners under water. This is particularly tragic for minority families whose net worth fell by more than half.

Just as workers' retirement prospects are increasingly affected by economic shocks, researchers at the New School, which is Robbie's alma mater, have shown that 401(k) plans also contribute to macroeconomic instability. Where Social Security helps shore-up household incomes during recessions, 401(k) plans encourage older workers to retire in boom times and hang on to jobs when asset values are depressed.

401(k) plans were invented by a benefit consultant working on a bonus plan for bankers. Congress never intended for them to replace traditional pensions as a primary investment retirement vehicle, and they are poorly designed for this purpose. Because 401(k) plans limit the scope for risk pooling and forego economies of scale, contributions to these plans must be nearly twice as high as traditional pensions to ensure a similar retirement income in retirement.

In addition, few participants have the time or ability to make good investment decisions. IRAs, primarily composed of funds rolled over from 401(k)s, offer fewer protections and typically have even higher fees. Our retirement system, which never worked well for low-income workers, now also fails the middle class. Our first priority should be expanding Social Security to replace some of the benefits cut in 1983 and better protect beneficiaries from rising health costs.

Second, we should take steps to preserve existing defined benefit pensions in the public and private sector. Contrary to conventional wisdom, most public pensions are in reasonably good shape, and those that are not are in trouble because elected officials neglected to make required contributions over many years. The focus should be on preventing this from happening in the future, not reneging on promises to workers or switching to defined contribution plans.

Third, we should address some of the worst problems of 401(k)s and IRAs before encouraging workers to save more in these plans. The Thrift Savings Plan offered to Federal workers is one model for reform because of its low fees, limited investment options, and the availability of low-cost annuities. However, it does not resolve the fundamental problems of market risk and upside-down tax subsidies.

Fourth, we should explore ways to make defined contribution plans more like defined benefit pensions, while recognizing that many private sector employers are not in a position to take on long-term liabilities. Senator Harkin's USA Retirement Funds and the California Secure Choice plan are two examples of this approach.

Last, but not least, we should reconsider our reliance on tax incentives for retirement savings. This approach is inherently inefficient because there is no way to guarantee that tax subsidies encourage people to save more, as opposed to shifting funds to tax-favored accounts. Nevertheless, a subsidy in the form of a refundable credit or Government match would be much more efficient and fair than the current system.

EPI's Guaranteed Retirement Account plan proposed converting tax subsidies for retirement savings into flat credits to offset the cost of universal accounts earning a modest rate of return guaranteed by the Federal Government. EPI is working on a variation with a Government guarantee that uses a balancing fund to maximize the share of retirees who achieve a target rate of return. Thank you very much.

Senator MERKLEY. Thank you very much, Doctor. We will now turn to Mr. Hiltonsmith.

STATEMENT OF ROBERT HILTONSMITH, POLICY ANALYST, DEMOS

Mr. HILTONSMITH. Thank you, Chairman Merkley and Ranking Member Heller, for the opportunity to testify today.

I am Robbie Hiltonsmith. I am a Policy Analyst at Demos, which is a public policy organization working for an America where we all have an equal say in our democracy and an equal chance in our economy.

I am happy to be here today to testify on the state of retirement security because as our other panelists have said, we really are at a crucial point here in that retirement security has declined immensely over the past 10 and 20 years, but it really is one of the lynchpins of economic security for the middle class.

One of the reasons, as other panelists have alluded to, is these—are the issues with 401(k)s and IRAs, defined contribution-type plans which have become the primary retirement savings vehicle

for most Americans. It is on those that I am going to focus my testimony today.

So in 2012, less than half of all private sector workers in the United States participated in workplace retirement plans. However, even those actively saving are still at risk of retirement security primarily because they have access only to a 401(k)-type plan. And as Senator Merkley mentioned in his opening remarks, these plans place all of the risk of saving for retirement on workers, exposing them to the risk of losing their savings in a stock market plunge or outliving their retirement savings, among others.

I was going to quote the stats that Monique already used. But, you know, 40 percent of people approaching retirement have nothing saved and even those that do the median amount is not enough to provide a secure retirement income. And it is, in fact, because of these issues with 401(k)s, these risks and high fees, that contribute to this retirement inadequacy.

So I will talk about the four major types of risk that 401(k) participants face, which are market risk, longevity risk, leakage risk, and contribution risk. So market risk. During the last stock market plunge, 401(k) and IRA assets lost $2 trillion in value and have only, for many, have only recently, mostly in the past year, seen their balances go beyond where they were.

So longevity risk, which is the possibility that account holders that outlive their retirement savings is, of course, increasingly worrisome as life expectancies of mostly higher earners rise. We know they are not rising much for the lower end of the income distribution. And individuals generally under-estimate their own probabilities of living to an old age, which makes this particularly difficult for them to calculate how long they are going to actually need to live.

So leakage from 401(k)s through pre-retirement withdrawals, loans, and cash-outs zapped nearly $75 billion from retirement accounts in 2010, and that was about a quarter of all money that was put into them.

And finally, we will talk about contribution risk. Workers under-contribute for three main reasons. Either they are not earning enough, which is one of the major problems here we are dealing with. They do not trust 401(k)s and financial markets in general, or they may not have the financial literacy to understand how these plans work or how much to contribute.

The effect of this contribution risk is especially evident in lower contribution rates among workers of color. They have rates for Latinos and African-Americans who do have lower average incomes, and surveys show trust for the initial markets less, trailing significantly behind contribution rates of white and Asian Americans.

Finally, the many fees charged by the funds in which 401(k) assets are invested make it even more difficult to accumulate sufficient savings. These fees, often around 1 percent of assets per year, can seem small. Over a lifetime, it can compound significantly to drain workers' savings. According to one of our reports, they can reduce the size of a typical household's nest egg at retirement by about 30 percent.

The issue is not that, of course, people are paying fees; it is that they are paying excessive fees, of course. They are paying fees that do not need to be paid. And there are a lot of factors contributing to these excessive fees from savers' and plan sponsors' lack of knowledge and, two, advice from plan investment advisors that often runs counter to savers' interests, in part due to the compensation structure of many of these financial advisors.

One recent study estimates that savers lose an average of nearly 1 percent in returns due to what they call fiduciary loss, which are, in essence, poor choices by plan fiduciaries, and in part due to poor or counter-productive advice by their financial advisors.

So Monique summed up pretty well a lot of different things we need to do to fix this, but it seems pretty clear that 401(k)s do need to be significantly reformed or even replaced if we are going to have individual savings plans be the primary retirement vehicle for most Americans.

Senator MERKLEY. Thank you, Mr. Hiltonsmith. Ms. Mitchem.

STATEMENT OF KRISTI MITCHEM, EXECUTIVE VICE PRESIDENT, STATE STREET GLOBAL ADVISORS

Ms. MITCHEM. Good afternoon, Chairman Merkley, Ranking Member Heller, and Members of the Subcommittee. Thank you for this opportunity to talk about the state of the U.S. retirement system and the role of the employer in helping to ensure retirement adequacy for the middle class.

My name is Kristi Mitchem and I am an Executive Vice President for State Street Global Advisors, the investment management arm of State Street Bank and Trust Company. State Street Global Advisors is one of the largest asset managers in the world, entrusted with over $2.3 trillion in assets. Importantly, we manage more than $305 billion for 401(k) and other defined contribution investors.

Having worked with retirement plan sponsors for the majority of my career, I recognize the important role that employers can play in assisting workers with retirement preparation. My objective today is to highlight the success that we are having with the largest employers in the United States that are helping their workers to achieve retirement adequacy within the context of a DC-dominated system, and to suggest ways in which we can make this success more universal by removing barriers that currently prevent many smaller companies from offering well-structured retirement savings programs.

When it comes to individual retirement planning and preparation, we believe the great divide is more around employer size than employee income level. Large employers are much more likely to provide a retirement plan, and when they do, the plan produces better results for those employees that participate in it regardless of their income level.

I would highlight several statistics for you that illustrate the impact of employer size on retirement readiness. Eighty-nine percent of large companies offer DC plans. However, only 14 percent of small employers sponsor some type of plan for their employees to save for retirement. The average savings rate in large plans is 7.3 percent. For the smallest plans, that drops to only 5.6 percent. The

average account balance in the largest plans is over two times the average across all plan sizes.

The question then becomes, why have large plans been more successful in developing individually funded plans that work? The answer, in my view, lies in the fact that the largest plans in the United States are leveraging changes in public policy and incorporating insights from behavioral finance to drive real improvements in retirement readiness. Specifically, they are taking steps to automate good behaviors, simplify choices, and enhance transparency, such as auto-enrollment, auto-escalation, and simplified investment menus.

A recent study conducted by the Employee Benefit Research Institute underscores the impact of these measures in helping employees achieve retirement adequacy. EBRI estimates 85 to 90 percent of younger middle-class workers participating in a plan that incorporates both auto-enrollment and auto-escalation would achieve retirement readiness.

So how do we replicate the large plan experience in the small plan market? Part of the answer, in our view, lies in helping convert small employers into large plans by supporting the pooling of retirement assets. Specifically, we would recommend that the current nexus requirements be eliminated for participant-funded retirement programs and that a safe harbor be offered to participating members of a multiple-employer DC plan, provided that certain best-in-class plan design features such as auto-enrollment and auto-escalation are incorporated.

Developing and encouraging the use of pooled plans would reduce the barriers to plan adoption among small companies by spreading the administrative and personnel-related costs across a number of employers. Importantly, it would also help smaller plans achieve the kind of fee leverage that larger plans now enjoy.

In other words, access to pooled plans would make retirement plan provision more attractive to small employers and would allow participants in these plans to keep more of what they save through lower plan expenses.

In conclusion, one of the unique facets of the U.S. retirement system is that the employer plays a central role in helping individuals to plan and save for retirement. What may not always be well understood, however, is that this workforce-centered design actually motivates savings in individuals that, left to their own devices, would not save.

A recent study shows that half of DC participants strongly agree or somewhat agree with the following statement: I probably would not save for retirement if I did not have a retirement plan at work. And for those with a household income of less than $50,000, that response rate increases to 70 percent.

Given the important role that employers play in enabling retirement savings, it is only natural that any exploration of how to improve the system begin with an examination of why certain employers are achieving success and others are not. In our view, the dominant explanatory variable is plan size. We have presented solid evidence that the largest employers in the United States are creating plans that work by incorporating auto-features and using their size and their scale to drive down costs.

The next step in the evolution of DC plans should be to bring aspects of that model to a wider range of plan sponsors. In our view, this can be accomplished, in part, by supporting the creation of well-structured, multiple employer plans. Thank you again for the opportunity to testify on the importance of ensuring retirement security for America's middle class. I would welcome any questions you might have.

Senator MERKLEY. Thank you very much for all of your testimony. We are going to turn first to Senator Warren for questions because she has an appointment that means she will have to leave in a few minutes. So we wanted to give her a chance to get her part of this dialogue underway.

Senator WARREN. Thank you very much, Mr. Chairman. It is very gracious of you and thank you, Ranking Member Heller, for letting me do this first.

Such an important topic and I have a whole stack of questions I would like to get through, and I am particularly interested in what you raised, Ms. Mitchem, about the importance or the opportunities presented if we look into pooling retirement plans for small employers. I really think getting more small employers into retirement systems is the key to getting more employees into retirement systems. So thanks very much on this.

I want to ask another question, though, about fees. Fees charged to administer and invest in retirement savings plans have an important impact on retirement security. The differences in fees may seem very small, but compounded over a lifetime of savings, they can make a huge difference. So I did a little math on this. For a median income worker who starts contributing 5 percent of her salary at the age of 25, having 401(k) fees that are set at 1 percent of assets, as compared with a quarter of a percent in assets, would leave that worker with $100,000 less at the time of retirement, forcing an additional 3 years of work to make up the difference.

If the fees are 1.3 percent, the cost at retirement would jump to over $300,000, and she would have to save 7.5 percent of her salary, a 50 percent increase, over her entire lifetime to make up that difference. In other words, fees matter.

In 2012, the Department of Labor implemented new rules for the first time that required disclosure of fees in 401(k) plans. So I just wanted to ask briefly, what has been the impact of required disclosure on fees? Anyone who would like to do that? Ms. Mitchem?

Ms. MITCHEM. I would be happy to take it and I would like to qualify that my commentary is really going to refer to the large plan market because that is what we service predominantly.

Senator WARREN. Fair enough.

Ms. MITCHEM. But if we look specifically at the largest plans in the United States, what we saw is that on the basis of that regulation, in combination, I would add, with other important trends like the move to lower cost index funds, has actually resulted in a decrease in fees of about 20 to 25 percent. So not only do fees matter, disclosures matter.

Senator WARREN. Absolutely. And that is driving down costs which means helping people have more secure retirements. Let me then take that to the next place. It is starting to help in 401(k) plans, but we still do not have anything in individual retirement

accounts. So individuals picking out IRAs are aware of the impact of fees. It is important that they be aware of the impact of fees on the bottom line.

There is more money held in IRAs than there is in 401(k)s, $5.3 trillion versus $3.5 trillion in 2012. And about 95 percent of the money in IRAs comes from funds that were rolled over from 401(k)s. And yet, there is no requirement that IRA fees be disclosed. Instead, companies could use misleading advertisements for no-fee IRAs that might actually have fees, and fees can be buried deep in legalese in different parts of the document.

So I want to ask, is there a principled reason why we should not require the same kind of disclosure for IRAs to make it clear up front what the fees will be for families? Mr. Hiltonsmith, would you like to jump in on that?

Mr. HILTONSMITH. Sure. I absolutely do not think there is any principled reason why we should not require that disclosure, but just to build on what Ms. Mitchem said, I actually think that the fee disclosures, both for 401(k)s and potentially for IRAs, need to go further than they do now.

Senator WARREN. Please say more.

Mr. HILTONSMITH. Yeah. I mean, just from my own discussions with people and with reporters who have been reporting on the issue, they have been finding people really confused by the disclosures, that sometimes they are appearing on Page 26 of their statements, and in some cases, they are not really saying very much more than they did before in that you still had—you always had that table of expense ratios and now you have got a different table and people still are not understanding, as you mentioned, the lifetime impact of these things, how big of a difference that 1 percent versus half percent versus, you know, 25 basis points makes.

And so, I really do think that not only do we need potentially some kind of standard for it, that these things need to be up-front and in some, you know, clear format like with credit cards might be required with them, and that also we really do need to give them some kind of estimate of how much of a difference, you know, these fees can make over a lifetime, because when they see 1 percent, they are like, Oh, you know, that does not seem like very much. But they do not realize that it is 1 percent of assets every year and that, in essence, is reducing their returns by 1 percent, you know, is the other way to think about it.

Senator WARREN. Well, thank you very much and I am out of time and I do not want to take more here, but I really do want to say, it sounds like such a small point, but getting not just disclosure, as you rightly say, Mr. Hiltonsmith, disclosure that is clear, that is in the same place on every document, that is reported in exactly the same way that it covers 401(k)s, that it covers IRAs.

And I will throw in the pitch what would have been my third question is when people rollover from 401(k)s to IRAs, that moment of marketing, that we make sure that people are fully informed. It is not the only thing we need to do in the retirement area. We need to do a whole lot more. But this is a step we ought to be able to do and do quickly. So thank you very much for having the hearing and thank you for your indulgence in letting me go first, and thank you all for showing up here today. Thank you.

Senator MERKLEY. Thank you. Thank you very much, Senator Warren. I wanted to turn to Dr. Morrissey, to some of your testimony. Your testimony makes very clear that Social Security is the foundation of so many Americans' retirement. According to the Social Security Administration's estimates, in 2011, nearly 64 percent of beneficiaries depend on Social Security for over 50 percent of their income, and 35 percent depend on it for 90 percent of their income.

Just to round those off, for one-third of the recipients or beneficiaries, it is the vast bulk, 90 percent or more; for two-thirds, it is at least half. And that is a very significant role to play. Social Security payments in that context keep a lot of our seniors out of poverty. Just 7 percent of Social Security retirees are below the poverty line. I think that should be claimed as a significant victory in the war on poverty.

But a lot of folks are right at the poverty line. And so, it is a very modest amount of assistance, which is why we are so interested in other vehicles. But, Dr. Morrissey, do you think the current Social Security benefits are enough to meet seniors' expenses, or do seniors deserve a modest raise in order to pay for medication, to put food on the table? Can Social Security do even more to provide retirement security for my citizens in Oregon and certainly the citizens of our entire Nation?

Ms. MORRISSEY. Yes, I very strongly feel that we should be expanding Social Security. In recent years, a lot of the talk inside the Beltway has been about cutting it. Fortunately, we have managed to avoid that. But I do not think most people are aware of the fact that benefits have already been significantly cut.

And when these benefits were cut in the early 1980s, and these cuts are still being implemented, nobody envisioned that we were going to, at the same time, be reducing the quality of benefits in the private sector plans at the same time, and also nobody envisioned that we would have the great recession, which is a once-in-a-lifetime catastrophe as far as the economy.

So for all of these reasons, those changes were in the wrong direction and we should be reversing these cuts. So I do not like to think of it as expanding Social Security as much as restoring benefits that were cut earlier that were understandable at the time, but that in retrospect were a mistake.

And yes, I completely agree that people do not realize that even though the poverty rate for seniors is fairly low, many, many seniors have modest incomes just above the poverty line and my colleagues at the Economic Policy Institute have documented there are many seniors—especially older women, who are very close to poverty or live very modestly.

Another way of looking at it is, if we need more retirement income, we can do it two different ways. We can urge people to save more and while continuing the cuts in Social Security that are still being phased in, or we can say, Well, nobody is over-saving, so we should expand this very efficient, very cost-effective system and, at the same time need to rely less on these savings plans that have just not worked very well.

Senator MERKLEY. Well, I do feel that as we see the decrease of defined benefit programs in the private sector, it greatly increases

reliance on the defined benefit Social Security program, and I strongly agree that we can do more to strengthen this program. So thank you for that point.

I want to turn to Treasurer Wheeler. While the conversation was going on on disclosures, I believe you were shaking your head or nodding and I am not sure if that was an affirmative or disagreement, but do you want to comment a little bit from your experience on the disclosure side?

Mr. WHEELER. Yes. Thank you, Senator Merkley and Senator Heller. I absolutely agree. My experience was and continues to be that it is not just disclosure of the fees, just as the rest of the panelists had indicated. It is the understanding of what those fees actually mean. And so, we heard a pitch for disclosure. We heard a pitch for consistency in that disclosure. So one vendor to another vendor to a third vendor and so on. You are going to see those fees presented in exactly the same format, in the same manner.

And then there has to be an understanding of what is underlying those fees. As Senator Warren pointed out, the miracle of compounding is very powerful when you are talking about a savings tool, and it is absolutely damning when you are talking about compounding fees that you are paying. And people need to understand what that actually means. So it is consistency, it is simplicity, and it is just, frankly, disclosure. I am profoundly in support of all three of those things.

Senator MERKLEY. And do you agree with the sense of extending that into the IRA realm?

Mr. WHEELER. I absolutely do. The end result for a consumer is exactly the same. They are in those vehicles for the purpose of saving for their retirement. So from my own personal perspective, it makes sense that you would have similar, consistent, and clear disclosure requirements for both.

Senator MERKLEY. You noted in your testimony—actually, my time is up, so I am going to turn this over. Well, I think we might go through a couple rounds of this——

Senator HELLER. I think so, yes.

Senator MERKLEY.——as long as we have time to do so.

Senator HELLER. Mr. Chairman, thank you. Mr. Wheeler, in my previous life, I was Chief Deputy State Treasurer. I was hoping some day I would become State Treasurer of Nevada. Instead, I became a United States Senator, I guess.

But needless to say, the questions that I have—do you, in your position, current position, do you manage the public employees' retirement system for Oregon?

Mr. WHEELER. Senator Heller, the answer is affirmative. The State treasury, in combination with the Citizen's Council, manages the public pension, the investments in the public pension.

Senator HELLER. So that is a commission that you are a part of, a commission that you are part of?

Mr. WHEELER. Absolutely, yes, sir.

Senator HELLER. How much was that, $86 billion?

Mr. WHEELER. Today the pension itself is about $68 billion, but in addition to that, we have other trust funds that we are responsible for, which total about $87, $88 billion today.

Senator HELLER. You talked about, in your testimony, a task force. Can you give me any update on how that is going?

Mr. WHEELER. The task force was just convened. It is actually meeting for the first time in the next couple of weeks. So we have not actually had the opportunity to meet yet.

Senator HELLER. What are the goals of that task force?

Mr. WHEELER. So the goals of the task force are, first of all, to identify potential savings tools, to identify the current baseline situation with retirement security in the State of Oregon. Each State has different issues. For example, in our State, we know that retirement insecurity disproportionately skews toward women head of households, toward minority head of households, toward small business employees, and as a small business State, that is of importance to us.

We are also supposed to evaluate any tax incentives that either currently exist or could potentially exist in the future that might help incentivize savings. We are supposed to look at the impact of pooled and professionally managed solutions on retirement security for the State of Oregon. And finally, we are supposed to come back to the 2015th legislative session with any particular ideas that fit within the sideboards that were provided to us by the legislature in the original legislation.

Senator HELLER. Is there any suggestion that the public employees retirement system should be involved in individual retirement accounts?

Mr. WHEELER. There is no suggestion that in the State of Oregon we will have public sector—excuse me. There is no indication and, in fact, we are required not to have members of the public participating in the public employee retirement system. Amongst the sideboards that were placed on the legislation, we are not increasing the risk to the State of Oregon through whatever means we recommend to the legislature. So the answer would be no.

Senator HELLER. Is your system healthy today?

Mr. WHEELER. Senator Heller, I believe the State of Oregon's system is healthy. We have gone through three rounds of reforms on the liability side. Today, our pension system is funded at 92 percent, excluding side accounts. It is funded at 98 percent, including side accounts. At the beginning of this recession, we were 107 percent funded. At the height of the recession, we were only 42 percent funded. So scrapping our way back to 92 percent makes me happy.

And I might further say that the investment pool was recently identified as the number one pension investment pool in the United States for pensions in excess of $1 billion in the 1-, 5-, and 10-year period. So I would answer yes, we are healthy today.

Senator HELLER. So using your numbers, are you 8 percent unfunded? You have an unfunded liability of 8 percent?

Mr. WHEELER. We have an unfunded liability, yes.

Senator HELLER. What is the dollar amount of that?

Mr. WHEELER. The—I do not have the current number with me, but I could easily provide that.

Senator HELLER. OK, OK. The only reason I ask is that Nevada is, quote-unquote, healthy also and they are about $10 billion unfunded. I worry sometimes about the health of these pension plans

and what is deemed to be healthy today and what is not deemed healthy.

Let me ask you another question. You know, in your position that if you are collecting Social Security and you have a State or municipal retirement also, that they reduce your Social Security by the amount that you receive in these pensions. What are your thoughts on that?

Mr. WHEELER. Senator Heller, I have not actually given this thorough consideration, so I would be reluctant to give an answer here in front of a Congressional Committee. It is something that I would want to consider carefully before you giving you an answer.

Senator HELLER. Anybody have an opinion on that? I do. I mean, if you have put——

Senator MERKLEY. Would you please let us know, Senator Heller?

[Laughter.]

Senator HELLER. I mean, if you put a lifetime of savings into Social Security and you are also participating in a municipal, State, local pension plan, that is your money. Why the Federal Government deems it is necessary to remove that money from your Social Security only because you have another pension plan, because you were responsible enough to have another pension plan, I think, is a mistake.

So if we are ever looking for something coming out of this Committee that I think would help those that are on Social Security, it is to make sure that they receive all the funds that they have actually put into it. It is their money. For the Federal Government to take it away from them because they are in a plan that you help manage, I think, is vastly unfair, vastly unfair. I think at that, I will turn it back to you.

Senator MERKLEY. Thank you very much. I want to turn, Dr. Morrissey, to a comment you made in your testimony, that if you have $100,000 at retirement and you convert it to an annuity to start at age 65, that you would not even be able to purchase an annuity that was equivalent to $5,000 per year. Or let me translate, that is roughly $400 per month.

In that case, if someone is getting Social Security in the range of about $1,400, that is equivalent—and I am asking this as a question, but my impression is—that is equivalent to having $300,000 to $400,000 in the bank when you retire.

Ms. MORRISSEY. Yes, it is. People tend to undervalue Social Security and are not aware of how much retirement wealth is in the form of Social Security benefits. When I said that these are the savings people have, I did not include measures of the value of Social Security benefits. If you include those, overwhelmingly, Social Security is by far the largest component of retirement wealth and it has been the case since Social Security grew to a substantial program.

Senator MERKLEY. Thank you. I think that it helps me get my hands around how significant those monthly payments are, or even a modest private sector pension, how it is equivalent to a sizable amount of savings.

Mr. Hiltonsmith, you mentioned the excessive fees. Is there any type of regulation or oversight of the level of fees that apply to IRAs?

Mr. HILTONSMITH. Are you asking me if there are currently any?

Senator MERKLEY. Yes.

Mr. HILTONSMITH. Not that I know of. Not that I am aware of, in any case. Monique, I am not sure if you know more about that.

Ms. MORRISSEY. What was the question?

Mr. HILTONSMITH. Is there currently regulation on IRA fees?

Ms. MORRISSEY. Not that I am aware of, no. In fact, I think it is kind of the wild west.

Mr. HILTONSMITH. Yes.

Senator MERKLEY. It is my impression that a significant number of fees are taken off the top before the returns are distributed. In that case, are the fees clearly disclosed to individuals?

Mr. HILTONSMITH. No.

Senator MERKLEY. I mean, it is just an issue of the format?

Mr. HILTONSMITH. Yes, the disclosure is there but it is hidden?

Senator MERKLEY. It is hidden, or is it that there is not disclosure?

Mr. HILTONSMITH. You know, I think it is a mix of these, in a sense. You know, I do not think people do understand that they are taken off the top, that when you see on your statement that you have gotten 10 percent returns for the past year, that those returns would say 12 percent before fees or 11 percent before fees. You know, I do not think they understand that that is, in essence, the way that they work.

And then, you know, furthermore, as Senator Warren and people have mentioned, they really understand just the magnitude of the impact of that over a lifetime, particularly with this, you know, compounding.

Senator MERKLEY. Thank you. I will come back to you in a moment, Ms. Mitchem. I wanted to turn quickly to Treasurer Wheeler. You mentioned that half of the private sector employees do not have an employer who provides a savings option, a retirement savings option. Do you have any specific suggestions for how more employers could be induced to provide such a retirement option?

Mr. WHEELER. Senator Merkley, in deference to the Committee work that we are about to embark on, I do not want to jump to the solutions, but there are a number of solutions that have been preferred here that would center around incentivization, around pooling resources to reduce the cost, around professional management to increase the return opportunities. But in deference to my colleagues on the task force, I do not want to get to the answer statement about what we are going to offer.

Senator MERKLEY. OK, great. I hope that as your task force proceeds, that my team can stay in contact and share that with the Committee because I think that would be relevant.

Mr. WHEELER. Yes, sir.

Senator MERKLEY. Ms. Mitchem, I wanted to invite you. You had some thoughts on the fee issue, disclosure issue?

Ms. MITCHEM. Yes. I just wanted to make sure that we were clear, that IRAs are regulated by the SEC. They invest predominantly in mutual funds. Mutual funds have very, very clear re-

quirements with regard to fee disclosures, both in the prospectus as well as the short form prospectus.

So I think the question is less about are the fees being disclosed. It is more about, do participants actually have the knowledge and the interest and the time to understand those fees and the impacts that they have on their investments, whether that be in an IRA or in a large DC plan.

I also think it is important to note, even if we just think about the name of it, an individual retirement account. The cost of those accounts are going to be more expensive because they are provided to individuals as opposed to large collective organizations. So I would just highlight that I do think there are things that we can do to help with the fee equation in the IRA market by looking at the 401(k) plan market.

I think one of the things that we could do is we could actually provide incentives for employers to keep employees in the plans post-retirement. I think another thing that we could do is we could foment broader access to retirement income options on 401(k) menus.

So one of the very interesting things that we find is when we look at 401(k) menus today, they are dominated by accumulation options. You can invest in the S&P 500 index. You can invest in the Lehman Aggregate index. What in most cases you cannot invest in is a strategy that helps you de-accumulate your assets.

So in order for people to stay on plans, to continue to get the fee savings that come with scale, we need to actually provide plan sponsors to offer lifetime income and longevity hedging within the 401(k) plan context.

Senator MERKLEY. Thank you. That response raised a whole series of questions which maybe we will be able to come back to in a few moments.

Senator HELLER. Ms. Mitchem, in your testimony, you said that retirement plan participants believe that they needed to save about 14 percent of their income, pre-tax wages for a retirement plan. How did you come to that conclusion?

Ms. MITCHEM. We actually produce a survey of plan participants twice annually. We go out and we ask actual plan participants, a random sample, statistically significant, what they believe is important to save for retirement and that is how we came up with the 14 percent.

Senator HELLER. So it is now State Street's opinion?

Ms. MITCHEM. No.

Senator HELLER. It is the survey that comes out.

Ms. MITCHEM. It is a survey. It comes from participants. And the reason why I think it is so powerful, if I might, Senator Heller, is because what it proves is that by auto-enrolling participants, we are actually auto-escalating them up to a significant percentage of——

Senator HELLER. Explain that to me, auto-enrolling.

Ms. MITCHEM. OK. So auto-enrolling means that when you come to work for a corporation, we automatically put you in the plan. You do not have to do anything. And if we set your initial contribution rate at 6 percent and then we provide for what is called auto-

escalation, so each year that you stay with us we actually increase your savings rate by a percent, we can get you up to those levels.

Senator HELLER. Are you increasing the employer contribution on that? Is that what you are doing?

Ms. MITCHEM. Well, what happens is both the employee and the employer increase their contribution in many instances.

Senator HELLER. OK. How do you manage with the risk and volatility of the markets today? If you take a look at the Federal Reserve and the very, very low interest rates that you have today, how could someone plan today knowing that these rates, frankly, are manipulated to the low standards that they are today in order to make sure that you have saved enough money? I mean, I know it is killing seniors today.

Seniors today that have money that is already invested with these low bond rates and everything else making it very, very difficult. How does someone at 25 years of age know what the rate of savings is going to be if you have the Federal Reserve making the kind of decisions and actions that they have been taking in the last 5 years?

Ms. MITCHEM. So I think the simple answer is they cannot know, and much of the best planning really relies on average returns. And so, the hope is, obviously, that if you save a reasonable amount of your pre-tax income, that over time you will achieve the types of returns that we have actually achieved in the past.

The other thing that I would just note there is that the most important contributor to what you have at the end of the day is what you put in. So we really do need to focus on getting people access to 401(k) plans and ensuring that they are putting enough away.

In terms of investment options, I would always recommend a well-diversified investment default. So that is a strategy that has a mix of different asset classes, stocks and bonds, to generate the types of returns that are hopefully capable of pushing people toward retirement adequacy.

Senator HELLER. Any other comments? Mr. Hiltonsmith, do you have a 401(k)?

Mr. HILTONSMITH. I do indeed. I have two of them.

Senator HELLER. Oh, you do?

Mr. HILTONSMITH. I have had trouble getting them into one.

Senator HELLER. In your testimony, you talked about reforming or replacing them. Do you want to reform or replace your own 401(k)?

Mr. HILTONSMITH. I spent the last 2 years doing that at Demos actually. We had a poor plan and I think this actually indicates one of the difficulties with, you can know all—you know, you can even have the knowledge of portfolio diversification and fees, but through your employer have little opportunity to change the plan your employer selected if it is not good. And so, this is what I have spent the past years doing at Demos, is getting us into a better plan.

Senator HELLER. So you have replaced?

Mr. HILTONSMITH. Yes. I did get us to switch plans to a lower fee and, hopefully, a better option.

Senator HELLER. But is that not what we are trying to achieve here in the marketplace, is lower fees? I mean, you had an opportunity to do that. If you look at your 401(k)——

Mr. HILTONSMITH. Absolutely.

Senator HELLER.——and taking out 1 percent, you are not happy with 1 percent because you are educated enough to know that that may be 30 percent of your plan?

Mr. HILTONSMITH. Absolutely.

Senator HELLER. Did you shop for lower rates? And you are able to do that. Why would the average American not also be able to do that, also?

Mr. HILTONSMITH. Well, I have an employer who is kind enough and collaborative enough to be able to listen. A lot of people do not feel like they are in that position, their jobs, or that they can actually push that even if they do have that knowledge. And then, of course, there is the whole problem with half employers or half of people not being covered by an employer plan whatsoever. We will have that, nearly half.

Senator HELLER. That is an issue. What would you replace it with then? Because you are talking about reforming and replacing 401(k)s. What would you reform or replace it with?

Mr. HILTONSMITH. Well, we need an option that shares some of these features that everyone here has talked about. One that does have better risk pooling, you know, that has better annuity options, that actually really does follow you from job to job.

As I mentioned, I have spent 2 years trying to roll my one 401(k) into the other and have yet to succeed. So it is not always an easy process. So something that, you know, so instead of having to go from 401(k) to IRA back to 401(k) to IRA and being for somebody of my age, 10, 15 times throughout their career, potentially, or maybe hopefully not, but for some of us, you know, we really need something that is portable and that, you know, has low fees, that is pooled, something that is a simpler option for people.

But that, as Ms. Mitchem said, you can contribute through your employer because that is really, as we have seen, if you have contributions through the employer, that is really where you get people to save and somebody's future, like auto-enrollment and auto-escalation really, really help because a lot of times, people do not even know it is coming out of their paycheck, to be honest.

Senator HELLER. Very good. Thank you.

Mr. HILTONSMITH. Thank you.

Senator MERKLEY. I think you were reminding us, Mr. Hiltonsmith, how much younger you are than we are when you talk about 10 or 15 more jobs.

[Laughter.]

Senator MERKLEY. Returning to this conversation about fees and disclosure, I was looking at a description of some of the fee structures that are in different accounts. This is a summary from the Consumer Federation of America. And it mentions there are front-end loads, back-end loads, redemption fees, deferred sales fees, revenue-sharing fees, maintenance fees, sales charges.

How is an average person to get their hands around this and evaluate and compare plans? Anyone want to jump into that?

Ms. MITCHEM. I would just say, you know, I think it is very difficult for the average person to become their own chief investment officer. It takes hours and hours and hours, as you know, to become expert on something as complex as finance. And so, I think that is why we need to make sure that really the center of our retirement security system is with the employer and with fiduciaries that are capable of understanding fees and making these decisions on behalf of plan participants.

Senator MERKLEY. So one idea that I recall from the Card Act debate—and this may have been Senator Wyden's bill, but if it is not, Senator Wyden, do not take offense. But it was an idea of rating cards according to their fee structure to help citizens have an easy handle. This is a five-star—I think it is a five-star rating. And so, folks who are sophisticated could evaluate all these front-end, back-end.

I am wondering, is something like that a possibility as something that would be helpful for consumers, Dr. Morrissey?

Ms. MORRISSEY. We certainly need to make fee disclosure more simple and salient and to make people aware of the cumulative effect of fees, how they erode your balances over time. That said, I had a similar experience as Robbie with trying to switch in our own employer. We ended up not switching, and the reason being that we economists were not able to convince many of the other staff people who were just looking at the historical returns at some of these actively managed funds, and to them that was what they were focusing on, not the fees. There is a limit to how heavy-handed, frankly, the economists could be in terms of saying, the historic returns on these actively managed funds are not what you should be focusing on.

Anyhow, so there is this tendency to be locked into high-cost plans. It is very hard to switch them out. So it is not competitive in any real sense. It is very hard to change plans and it is very hard to make people understand how these fees function.

For that reason, I think we do need much better disclosure. We need to do it in a way that illustrates to people the cumulative effect in terms of eroding account balances. But I also think that we need to move toward a structure more like what the Federal employees have in the Thrift Savings Plan where you really have a limited number of investment options and all of them make some sense.

Now, that said, I actually have some issues with the TSP. I think that their life cycle funds, which are about to become potentially the default investments, are very aggressive. But nonetheless, at least, you know, each of those funds—you can make it a defensible case for why you should invest in them, whereas a lot of what we have with the investment options in a lot of 401(k)s and IRAs, really, nobody should be investing in them.

Senator MERKLEY. So I have 1 minute before I turn this conversation back over. So is there a connection between some of the higher fee structures and the sales commissions that go to those who are marketing the funds? Is that a concern? Does anybody want to weigh in on that?

Mr. HILTONSMITH. Sure, I would be happy to quickly. Yeah, absolutely. We are doing it the way—not only the sales commission for

some of the marketers, financial advisors, but honestly, even for the way that the planned—you know, the plan custodians and plan record-keepers get their revenue as well. They get, you know, these—it is called revenue-sharing payments from the mutual funds that they put in a particular plan.

So there is a couple layers where—and both the commissions and these revenue-sharing payments are usually, you know, some kind of share of the fees charged by a fund. So this really can—you know, there are several layers of this where there can be incentives to push higher fee funds kind of against people's best interests.

So it is not to say the employers do not, you know, have a fiduciary duty to look out for the lowest fee funds, but in many cases, like with Demos, I mean, honestly, before I came there, nobody had any idea that paying 1.7 percent for an international fund was not the best, or .9 percent for our index fund.

Senator MERKLEY. To clarify, are you saying the revenue-sharing payments went to the employer or to the original sales force?

Mr. HILTONSMITH. So that the revenue-sharing that I am talking about is between the mutual funds and kind of the plan record-keepers, the people who bundle the mutual funds and other vehicles into plans.

Senator MERKLEY. I see.

Mr. HILTONSMITH. So, for example, if you have one corporation's name on a 401(k) and other mutual funds in that plan, there is a revenue-sharing between those mutual funds and that bundler, and then there is also the front-end commission and stuff that you talked about as well.

Senator MERKLEY. Thank you.

Senator HELLER. Mr. Chairman, thank you. Mr. Hiltonsmith, I want to come back to you for just a minute because of some of the numbers that you reported, talking about the 1 percent fee accumulated over a lifetime may be as high as 30 percent. It was just pointed out to me that in your calculations, it did not include the employer contributions. Can you tell me why you did not include the employer contributions in that calculation?

Mr. HILTONSMITH. Yeah. You know, for one, having the employer contributions, the fee still comes off those, so that kind of—the 30 percent calculation is really just based on what percentage, because the way to really think about fees is what percentage of overall returns, long-term returns they are eating up.

So if we talk about an aggregate dollar amount that it costs, like as Senator Warren referred to, $100,000 to $200,000, then yes, employer contributions would affect that, but not this kind of what share of, you know, how much it lowers the overall nest egg by that percentage. That would not change whatsoever.

But we did not include employer contributions because, honestly, there has been a tendency toward fewer contributions by employers. We have seen their share. There is a number I like to quote. Their share of plan expenses has gone to—they used to pay about 20 percent of all plan expenses on the expense side and now they pay about 9 percent.

But also, the amount that they are matching, the generosity and stuff, in many cases, has gone down. You have seen the news infer some corporations trying to cut their matches and, you know, many

small businesses do not match or do not have the luxury to match whatsoever. So we kind of want to just focus on what you yourself put in, in our calculations.

Senator HELLER. Ms. Mitchem, in Nevada, and I always hate to say this, we have the highest unemployment, highest in foreclosure, highest in bankruptcy, and you can imagine now how many people are now risk-averse to what has happened in the last 5 years. How has this changed savings and investment plans for the average American after what they have seen in the last 5 years?

Ms. MITCHEM. So I think you are absolutely right in that participants' attitudes toward risk have shifted. The question then becomes whether that really impacts their ultimate allocations. And what we find generally is that most participants never make a change, at least for several years, to their initial investment allocation.

So their attitudes may have changed, but the likelihood is that it probably has not been reflected in how they invest. I would also note that one great corrector for that just to come back to auto-enrollment, is auto-enrolling people and putting them into a well-diversified default fund.

So it actually takes those sort of periodic times when people may be overly risk-averse, just at times when perhaps they should be accepting risk and corrects for that through a well-diversified default.

Senator HELLER. Does the auto-enrollment allow an individual to determine the risk they are going to take?

Ms. MITCHEM. No. I mean, auto-enrollment is typically placed into a qualified investment default alternative, or QDIA. There are three types of QDIAs permitted under the safe harbor by the Department of Labor. One of those is a target date fund, which we have discussed.

Another is a balanced fund which generally meets a demographic test for being suitable for the employee population at large. And the third is a managed account, which would be a customized allocation just for a specific individual. If an individual, once being auto-enrolled and defaulted, decides to make a change to the investment option, they can do so.

Senator HELLER. OK. I want to thank all the witnesses for being here today. I am not able to ask any more questions, but I certainly appreciate your time, your energy, your efforts, and your testimony and what you have brought to the table today. So thank you. Mr. Chairman, thank you.

Senator MERKLEY. Thank you very much, Senator Heller. I wanted to go back to the conversation about why a lot of employers do not set up a plan. Treasurer Wheeler, you noted that half employers, or at least maybe it was half the employees, do not have an employer who provides a plan.

At one point I was an executive director of a small nonprofit, and I thought, you know, there should be some form of option here for employees. And I was told to take a look at the SIMPLE IRA, acronym SIMPLE. And so I did, and after several important meetings of trustees of the nonprofit, I presented this and said this is how it will work, they approved it, and we set it up.

It was pretty easy to set up and it was pretty easy to operate and it was a fairly modest minimum requirement. I was just trying to check it while Senator Heller was speaking. But I think it is the same now as it was then, which was a requirement of 2 percent, matching the first 2 percent of your employees' contributions, or 2 percent of their wages up to that amount that they contribute.

And so, I look at that and I think, given that this is a fairly modest employer contribution, and I think the whole idea behind the SIMPLE IRA was, hey, we have a problem with employers dealing with complex 401(k)s or other vehicles, let us just make something very straight-forward.

Why has that strategy not worked? What could we do to encourage more employers to set up a modest retirement structure for their employees? It is like raising their employees' income since the employees can set aside those funds tax-free. It seems like a win-win. Any thoughts on that?

Mr. WHEELER. Sorry about that, Senator. I do have some thoughts and this is something that I hope that our task force in Oregon focuses a considerable amount of time on. Your supposition is correct, that if we could create a pooled product and if that product was simple, if that product was cost-effective, if it was easily accessible by employees, it makes sense that more people would want to save for retirement, since our constituents tell us this is something they would like to have.

Some of the current obstacles that we have already anecdotally come across: If you are a small business employer, and in our State, Senator, most people are employed by small businesses, the small business owner typically does not have a lot of time to give toward things like setting up a retirement plan.

That, in combination with retirement plan providers who, frankly, are not that interested in supplying an institutional quality retirement plan to a very small business, the economies of scale that come into play with a large employer also hold true on the fee side. It is just more productive from the perspective of a provider to find a large employer as opposed to a micro-employer.

There are other issues as well. A lot of small business owners already struggle with the issue of mobility of their workforce, and while 401(k)s and the like are, in fact, transportable, they go with the employee. They can roll them over into other plans. For an employer that is looking at an employee who is not going to be there for very long, it may not just be worth the effort.

So if we could create some sort of a pool that is successful, that is simple, that has low fees, that has institutional quality fund management for those types of employers, I believe there would be a strong interest in it, Senator.

Senator MERKLEY. Thank you very much. Anyone else want to jump in on this question of how do you—and I should note that I should expand to if anyone has comments on the myRA, which the President put in his State of the Union as one approach to fill in for folks who do not have access to retirement plans, wants to share any thoughts on that, on that policy proposal?

Ms. MITCHEM. I guess I would just make two comments. I think with regard to myRA, it gets at the heart of the conversation we are having today, which is how do we actually expand access and

get a larger percentage of American workers actually covered by workforce retirement programs.

And then I think with respect to your smaller plan question, again, I would probably go back to much of what I put in my testimony, which is, everything that we see in the context of behavioral economics tells us that if we want someone to do something, let us make it easy for them to do it. Let us make it simple and let us make it straight-forward.

And I think if we can bind some of the features of SIMPLE with some changes that allow multiple employers to pool their retirement assets together, I think that we could get—or at least go a long way toward increasing access at the smaller end of the marketplace, and that is certainly what I would suggest.

Senator MERKLEY. And when you say that, does it resonate with what Treasurer Wheeler just referred to?

Ms. MITCHEM. It absolutely resonates with what he is referring to. I think that, you know, one of the things that I really liked about what Treasurer Wheeler said is that one of the nice things about really fomenting more collective pools of retirement assets is that they would spur innovation from providers, I think, and a relatively under-served market would get more attention and that would be a good thing.

Senator MERKLEY. So one thing I was struck by in one of your testimonies was the comment that 401(k)s and IRAs are inherently less efficient. I think the comment was by a factor of 50 percent. Was that your comment, Dr. Morrissey?

Ms. MORRISSEY. Yes.

Senator MERKLEY. Now, in a normal defined benefit, if you die, then you are no longer pulling funds from the pool on an IRA or a 43(b) or 401(k). If you die, you still have a balance that goes on to your estate. Is it because of that estate effect that a defined benefit pension plan is so much more efficient?

Ms. MORRISSEY. That is part of the explanation. And, in fact, for this reason, you could argue then that we are overstating the case. By the way, I came up with that calculation. But independently, also, the National Institute on Retirement Security came up with similar estimates, and in my case, I had help from Ron Gebhardtsbauer, who is a very well-known actuary, and he checked my numbers and I thought he had also independently come up with similar figures.

It does assume that the average person with a DC plan is going to die and bequeath some to their heir, because they need to have a little bit extra set aside for longevity risk, but a lot of the difference also had to do with, we were assuming, for example, I forgot exactly, but I think a 100-basis-point difference in the rate of return. So there were other inefficiencies worked into the system.

But some of it is because you do have to set aside a little bit extra because you just do not know how long you are going to live and you do not have access to a cost-effective annuity.

Senator MERKLEY. OK. Related to this, there was a comment—and this was also yours, Dr. Morrissey—that the tax expenditures, so the money that we provide through the Tax Code to support retirement, that the vast bulk of it goes to the best-off Americans.

Actually, this may not have been from you, but this is the statistic I have in front of me, that 66 percent of the tax expenditures to help folks plan for retirement goes to the richest one-fifth of Americans, and that the bottom 40 percent get only 7 percent of those tax expenditures. So essentially, we are spending our public resources, if you will, overwhelmingly to help the best-off who have the least need for retirement. Is there anything about that observation that provides insights on ideas for changing how we do this?

Ms. MORRISSEY. Well, first of all, yes, I did—we estimated that it is even more than that, but I think CBO's numbers are that about two-thirds. So either way, most estimates are that about two-thirds go to the top income quintile. Avoiding the whole issue of how these tax expenditures actually work, which is that they incentivize investment income rather than incentivize savings, it is striking if you look at President Obama's earlier proposals to expand the Saver's Credit, and also at his more recent proposals to limit the tax deferral to 28 percent, the cost of the former is on the order of $3 billion a year and the cost savings from the latter is about a billion dollars, compared to the total cost of these tax expenditures for DC plans, which is on the order now of about $60 billion or $70 billion. President Obama's proposal to expand the tax Saver's Credit, which would do it in a very smart way—by making it refundable, and also a fixed amount. It would be 50 percent match, like a Government match.

He was also raising the limit for the eligibility up to, I think, $85,000 for married couples. So this is an enormous expansion of the Saver's Credit, and yet, the cost would amount to about $3 billion per year. So we are spending $60 billion, $70 billion a year and this supposedly big dramatic change in the Saver's Credit, which I wholeheartedly support, would still only cost a fraction of what we are already spending.

Likewise, the proposal to limit the amounts going to the very wealthiest people by capping it at 28 percent only saves about a billion dollars a year. So if both proposals, which I think are both good ideas, were implemented, it would only have a very small effect on the cost. I mean, it would only be a minor correction.

They are well worth doing. They are a politically difficult lift, I understand that, but it is an illustration of just how bad the problem is and how even things that are vehemently opposed by the industry are really actually just minor corrections of an overwhelmingly bad system.

Senator MERKLEY. Thank you. Ms. Mitchem, did you want to comment on this?

Ms. MITCHEM. Yes. I was just going to comment that, we do find that auto features are really a great equalizer, and there is some recent research that was actually done by Brigitte Madrian and a group of researchers out of Harvard University. And specifically, they looked at a Fortune 500 company that was implementing auto-enrollment and auto-escalation.

And they looked at it pre and they looked at it post. Pre, they found the kind of distinctions that we are talking about where groups, on the basis of race and ethnicity, and even sex, did not participate at the same levels in the 401(k) plan.

Senator MERKLEY. I am afraid to ask. Which gender is the better saver?

Ms. MITCHEM. Well, actually, women, without auto-enrollment actually under-save.

Senator MERKLEY. Oh, under-save?

Ms. MITCHEM. Yes, along with blacks, Hispanics, lower-income workers, younger workers. So those are the people that actually fall out of the system when you do not use auto-enrollment and auto-escalation. When you use auto-enrollment and auto-escalation, we find it to be the great equalizer.

So, you know, the reality is that everyone suffers from inertia, but people who are under-educated or maybe do not trust markets actually suffer from inertia at an even higher degree. So when we combat inertia with smart things like auto-enrollment and auto-escalation, we get better results for everyone, and, I think, ultimately a much more even distribution of the tax incentives across income groups, race groups, and sexes.

Senator MERKLEY. That is very interesting. I will follow up on that study. Thank you. Mr. Hiltonsmith?

Mr. HILTONSMITH. I would just add one minor thing to that, that I think auto-enrollment is certainly helpful, but can only go so far as far as correcting these disparities in who is getting the tax benefits, because, you know, as of right now, as we know, the cap on tax deferred savings is $17,500 a year. There are some ways to get around that actually.

But, you know, we have to think of what percentage of workers can actually afford to save $17,500 a year. So, you know, even if we get more people into plans and get them saving more, you know, somebody who makes $50,000 a year just is not going to be able to save that much, while someone who makes $300,000 a year probably can.

So, I mean, you know, there—based on the level of that, you know, that cap, I think that is going to—inequality is going to remain no matter what we do.

Senator MERKLEY. Point taken. Let me turn to the auto-enrollment. When I set up the SIMPLE IRA for the nonprofit, I sat down with each member of the team and said, Please, just sign up. Fill out this form. In a month from now, you can get off if you want. But look, where else are you going to get 100 percent return, because we are matching the funds you set aside.

And folks who made that initial decision at that point, as you pointed out, there is a lot of inertia, that people tend to stay with what they have done. Now, when you are talking about auto-enrollment, is it then—is it legal now for an employer to basically automatically sign people up without them signing anything that says, Yes, you may take X amount out of my paycheck? Does that extend to almost all the retirement vehicles? Can you do auto-enrollment now in the SIMPLE plan, for example?

Ms. MITCHEM. You can. So auto-enrollment is provided for under the Pension Protection Act, another specific exemption that was written by the DOL. It does have certain requirements that go along with it, so there are notification periods. So you need to let people know that you are actually going to be auto-enrolling them into a plan, so that is an important consideration.

A second thing that you need to do to qualify for the safe harbor is to place the assets that come in under auto-enrollment in what is called a qualified default, and we already had a discussion around what those are. And the third thing is you have to meet certain thresholds with regard to employer matching, to qualify for the safe harbor.

Senator MERKLEY. And then you mentioned auto-escalation.

Ms. MITCHEM. Yes.

Senator MERKLEY. And is that a set percentage that changes as people's income goes up or is that——

Ms. MITCHEM. So generally in the United States, auto-escalation is done with what they call a time factor. So the most common implementation that we see is that employers will escalate contributions on an annual basis at 1 percent. And when we talk about things that could really improve the system, even in the large plan market, I think you have hit on two really critical ones.

The first is this idea of inertia. If we auto-enroll people at 3 percent, where do they stay? 3 percent. And left to their own devices, incidentally, most people would save at the 6 percent level. So one of the things that we need to do is we need to encourage large plans to be auto-enrolling and using an initial contribution rate of 6 percent.

The second thing we need to convince large plans to do is be more aggressive around these escalators for contributions. As I mentioned today, it is 1 percent per annum. I would love to see that be 2 percent.

Senator MERKLEY. Folks, our time has run out. Just this conversation has raised so many different pieces of this puzzle. So it provides a lot of food for thought. I am certainly going to be sharing many of these ideas with my colleagues as we wrestle with this nationally.

As a number of you noted, this is not just an issue for the individual person, but it is an issue for our national economy, for generational issues, for folks' dependence on a safety net or lack of need to depend upon a safety net. And so, it is an item of great interest to Congress. I appreciate the insights that all of you have brought to this gathering.

I need to formally note something. Hold on a minute. The record will stay open 7 days. Members of the Committee may submit questions to all of you, and if you would be so kind as to respond to their questions, we will include that in the record. It would be very helpful. Thank you. With that, I adjourn this hearing of the Subcommittee.

[Whereupon, at 4:36 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF TED WHEELER

STATE TREASURER, STATE OF OREGON

MARCH 12, 2014

- My name is Ted Wheeler and I am the State Treasurer in Oregon. In that capacity, I manage the State's investment program, protect our strong credit rating, and oversee the protection of public deposits for more than 1,000 local governments.
- Before I entered elected office, I worked in the financial services industry including at a Portland investment firm called Copper Mountain Trust, which specialized in private sector retirement planning.
- I am also a fiduciary for the financial interests of Oregonians, and my concerns about the future of Oregon families are what bring me here today.
- Thank you for your attention to the critically important matter of retirement security for the middle class. More needs to be done, and quickly, to reduce the profound economic impact of what I believe is a generational crisis, which threatens to plunge seniors into poverty, disrupt entire families and impact the overall economy.
- In Oregon and across the Nation, a lack of sufficient retirement savings threatens family security and quality of life, and could place an increasingly heavy burden on social safety net programs
- Time is not our ally.
- In Oregon, with bipartisan support, we decided to take a hard look at retirement security. Oregon's senior population is projected to double in the next 20 years. At the same time, roughly half of workers have no retirement savings option at work, and a study released last year by AARP Oregon found that one in six Oregonians aged 45–64 has less than $5,000 in a retirement savings account.
- That puts off some pretty big alarm bells. This is a demographic wave and we are about to get swamped. It is quickly moving from the realm of being a personal issue to becoming a social issue.
- We know it's hard to save, especially for the middle class. It's harder to make ends meet with stagnant wages, skyrocketing post-secondary education costs, and uncertainty about the future of health care. As I travel the State, the stories I hear simply confirm the data: Oregonians prioritize today's pressing economic needs over the retirement savings needs of tomorrow and too many will be woefully underprepared.
- Many may not be able to stop working. For too many, the golden years could be fool's gold.
- A huge number of Oregonians are primarily dependent on Social Security for retirement. The typical benefit for the roughly half a million Oregon retired workers in 2012 was $15,287 a year.
- How significant is it: Without Social Security, the elderly poverty rate in Oregon would have increased from 1 in 14 (7 percent) to 2 in 5 (40 percent).
- In December, I helped to convene a roundtable of State Treasurers and we agreed that this subject deserves America's attention.
- Next week, as laid out in our bipartisan legislation, I will convene the first meeting of a new task force to consider how Oregon can help incent more retirement savings, and to potentially expand the availability of pooled and professionally managed funds for workers.
- Among our questions will be the following:
  1.) What options can we create, expand upon, or new models can we create to bolster the savings of private sector employees who currently do not have access to a plan through their employer? 2.) What role, if any, can the successful investment program run by the State Treasury play in this effort?
- I think it is appropriate that these conversations occur at the State level. Different States will have different solutions based in large part of their differing expectations of government.
- Those innovations and conversations can help to guide your conversations about Federal policy, much like States' efforts helped to shape the 529 laws that provide beneficial tools to save for higher education and vocational training.
- Again, thank you for your audience and your awareness that retirement security is getting further away—if not unreachable—for too many Americans.

- It's a bipartisan concern and time is not our ally.
- Thank you for this opportunity.

PREPARED STATEMENT OF MONIQUE MORRISSEY, PH.D.

ECONOMIST, ECONOMY POLICY INSTITUTE

MARCH 12, 2014

How has the financial structure of Americans' retirement evolved over the past 50 years?

Retirement security advanced in the postwar decades. Participation in employer-based plans increased from 25 percent of private-sector workers in 1950 to 45 percent in 1970 (public sector workers were already largely covered) (EBRI 1998). Social Security became nearly universal and benefits expanded. The Social Security contribution rate more than quadrupled in the second half of the 20th century to pay for cost-of-living adjustments and other new benefits (Martin and Weaver 2005; SSA n.d.).

The 1980s began a period of retrenchment. Social Security cuts enacted in 1983 gradually raised the normal retirement age, delayed cost-of-living adjustments, and taxed some benefits. Legislation enacted 10 years later increased the taxation of benefits. The National Academy of Social Insurance has estimated that the 1983 and 1993 cuts, when fully implemented, will reduce Social Security retirement benefits by 24 percent (Reno 2013).

In the private sector, defined-benefit pensions were largely replaced by defined-contribution plans, shifting costs and risks from employers to individual workers. In 1989, full-time private-sector workers with retirement benefits were divided roughly equally between those with defined benefit pensions and those with defined-contribution plans, including roughly 20 percent who had both. By 2010, 50 percent of these workers had a defined-contribution plan and 22 percent had a defined-benefit plan, including roughly 13 percent who had both (Wiatrowski 2011).

In theory, the shift from defined-benefit pensions to defined-contribution plans could have broadened access by making it easier for employers to offer retirement benefits. However, participation in employer-based plans, which peaked at just over half (52 percent) of prime-age wage and salary workers in 2000, fell to 44 percent in 2012. This occurred even though the Baby Boomers were entering their 50s and early 60s when participation rates tend to be high (Copeland 2013; Morrissey and Sabadish 2013).[1]

An increase in the labor force participation of women and, more recently, older workers helped mitigate the impact of the shift toward a do-it-yourself retirement system. The labor force participation of Americans 65 and older is now higher than it has been in half a century (author's analysis of Bureau of Labor Statistics data). However, working longer is not an option for many older Americans. About 40 percent of workers retire earlier than planned due to poor health, caregiving responsibilities, job loss, or similar reasons (Kingson and Morrissey 2012). Many other older workers continue working under difficult conditions, unable to retire from stressful and physically demanding jobs, or end up among the long-term unemployed.

What have been the recent trends in U.S. retirement assets?

As 401(k)s replaced traditional pensions and the population aged, assets in individual and pooled retirement funds grew faster than income. By 2010, average savings in retirement accounts had surpassed the value of annual household income. However, retirement insecurity worsened as retirement wealth became more unequal and outcomes more uncertain (Morrissey and Sabadish 2013).

Mean household savings in retirement accounts increased from around $24,000 in 1989 to around $86,000 in 2010. However, the growth was driven by a small number of households with large balances. Median savings—the savings of the typical household with a positive balance—peaked at around $47,000 in 2007 before declining to $44,000 in 2010 in the wake of the Great Recession, even as the Baby Boomers were entering their peak saving years (Morrissey and Sabadish 2013).

For many demographic groups, the typical (median) household has no savings in retirement accounts, and balances are low even when focusing only on households

[1] This is based on Current Population Survey data for wage and salary workers aged 21 to 64. Overall participation is even lower: 39 percent of all workers in 2012 (Copeland 2013). An employer survey, the National Compensation Survey, which tends to show somewhat higher participation rates, also shows a declining trend (EBRI, n.d.).

with savings. For groups for whom there is sufficient data, only white households, married couples, and college graduates are more likely than not to have retirement account savings. Even for these households, savings are very unequally distributed (Morrissey and Sabadish 2013).

Most Americans approaching retirement have little or nothing saved in retirement accounts. In 2010, 40 percent of families in their peak saving years (aged 55–64) had nothing saved in retirement accounts and 10 percent had $12,000 or less according to data from the Federal Reserve Survey of Consumer Finances (Bricker, *et al.,* 2012; Rhee 2014). Though the median amount for families with savings was $100,000, this is not even enough to purchase a $5,000 a year joint life annuity starting at age 65 (author's analysis of Bricker, *et al.,* 2012).[2]

Home equity and other forms of wealth may also be tapped for retirement. Net worth, like retirement savings, has risen faster than income since 1989 and grown more unequal (Morrissey and Sabadish 2013). Taking into account home equity and other assets and liabilities, median net worth for older families was $179,000 in 2010—close to the median home value (Bricker, *et al.,* 2012; U.S. Census 2012).

Retirement account savings are very unevenly distributed. In 2010, a household in the 90th percentile of the retirement savings distribution had nearly 100 times more retirement savings than the median (50th percentile) household, which had a negligible amount. The top 1 percent of households had over $1.3 million in retirement account savings. All told, households in the top fifth of the income distribution accounted for 72 percent of total savings in retirement accounts (Morrissey and Sabadish 2013). Assuming upper-income households receive tax subsidies at least proportional to their share of savings, this suggests that the lion's share of tax subsidies for retirement savings go to high-income households.

Retirement-income inequality has grown because most 401(k) participants are required to contribute to these plans in order to participate, whereas workers are automatically enrolled in defined-benefit pensions and, in the private sector, are not required to contribute to these plans. Higher-income workers are more likely to participate because they have more disposable income and are more likely to work for employers who provide matches (CBO 2013; Morrissey 2009). In contrast, middle- and lower-income workers find it difficult to save for retirement, especially since inflation-adjusted wages for most workers have stagnated over the past four decades. Higher-income households also have a higher investment risk tolerance, allowing them to better take advantage of retirement savings incentives that depend on investment earnings.

Disparities in retirement savings partly reflect differences between workers at different life stages and between those with and without accounts, some of whom may be covered by defined-benefit pensions. However, focusing only on workers in their early to mid-50s with retirement account savings, the mean is still 2.5 times larger than the median. In contrast, defined-benefit pension benefits appear fairly equally distributed among older participants, with the mean benefit only slightly larger than the median benefit (Morrissey and Sabadish 2013).

There are stark differences by race, ethnicity and education. Black workers' participation in employer-based retirement plans, including defined-benefit pensions, used to be similar to that of white workers, but has lagged in recent years. Hispanic workers, who have always had low participation rates, have fallen even further behind. As a result of this and other factors, white households have roughly six times as much saved in retirement accounts as Hispanic and black households. A similar gap exists between college-educated and high school-educated households (Morrissey and Sabadish 2013).

Lower-paid groups are ill-served by a retirement system that shifts costs and risk onto workers, including the risk of outliving one's retirement savings. Women, blacks, Hispanics, and seniors aged 80 and older are more likely to be economically vulnerable in old age, defined as having an income that is less than two times the supplemental poverty threshold (Gould and Cooper 2013).[3] Though women by some measures are narrowing gaps with men, this is mostly because men are faring worse and because married women are less dependent than they used to be on their

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[2] Author's analysis using the Thrift Saving Plan Retirement Income Calculator on March 7, 2014, based on an annuity interest rate of 2.875 percent, a 50 percent survivor annuity, and rising payments to offset inflation.

[3] This is based on Current Population Survey income measures that exclude lump-sum (as opposed to periodic) distributions from retirement plans. However, data from the Survey of Consumer Finances and other sources suggests that retirement account savings for these groups are modest.

husbands' benefits. Unmarried people, especially women, tend to be less prepared for retirement than their married counterparts.

The retirement crisis is growing. It is often suggested that future retirees, who are less likely to accrue pension benefits, will have more saved in retirement accounts when they retire than Baby Boomers, many of whom were covered by traditional defined-benefit pensions at some point in their careers. However, the Center for Retirement Research has found that workers today tend to have lower wealth-to-income ratios than earlier cohorts at similar ages, with younger cohorts at greater risk (Munnell, *et al.,* 2012). Even before the 2008 downturn, wealth-to-income ratios were stagnant despite lower defined-benefit pension coverage, declining Social Security replacement rates, rising Medicare premiums, and other reasons younger workers should be saving more (Delorme, *et al.,* 2006). As a result, the Center estimates that 62 percent of GenXers are at risk of seeing a significant drop in living standards at retirement, compared with 44 percent of Baby Boomers (Munnell, *et al.,* 2012).

How did the financial crisis and aftermath affect retirement security?

Retirement prospects were hit hard by the collapse of the housing bubble and ensuing Great Recession. The share of households with savings in retirement accounts contracted after the downturn. The drop-off was particularly sharp among older households, a bad sign for Baby Boomers' retirement prospects. Though aggregate savings in retirement accounts continued to grow faster than income, retirement savings grew more unequal and the median account balance declined (Morrissey and Sabadish 2013). Household net worth took an even bigger hit, as the bursting of the housing bubble resulted in a $13 trillion loss of household wealth (Bosworth and Smart 2009).

What roles have homeownership played in the ability of the middle-class to retire?

Historically, most household savings have taken "brick and mortar" form, which had advantages and disadvantages. On one hand, traditional 30-year fixed-rate mortgages were a form of enforced saving and provided many people with secure low-cost housing in retirement. On the other hand, household assets were not diversified. Even before the housing bubble burst, regional declines could result in homeowners facing job loss and collapsing home equity at the same time.

Many families borrowed to buy homes in the bubble years only to find themselves underwater—with negative home equity—after the bubble burst, a situation exacerbated by the disadvantageous terms of many of these loans. This was particularly tragic for minority communities who had earlier been shut out of housing markets. According to a Pew analysis of Survey of Income and Program Participation data, the real net worth of Hispanic and black households fell by 66 percent and 53 percent respectively between 2005 to 2009, compared with 16 percent among white households (Kochhar, *et al.,* 2011).

What are the macroeconomic impacts of retirement security issues?

The shift to a retirement system based on individual savings means that workers' retirement prospects are increasingly affected by shocks to stock and housing markets and broader economic trends.

In the past, cyclical downturns in the economy prompted increases in early retirements, as measured by declines in the share of 60–64 year olds in the labor force. Thus, early retirees made way for younger workers when jobs were scarce. But as 401(k)s have replaced traditional pensions, early retirement is no longer associated with labor market weakness but rather with housing and stock bubbles. Thus, in the late 1990s, when labor markets were tight and the stock market was booming, there was an uptick in early retirement, though the trend toward later retirement resumed after the dot-com bubble burst. Likewise, the labor force participation of 60–64-year-olds continued to climb during the 2008–09 recession (Morrissey 2008).

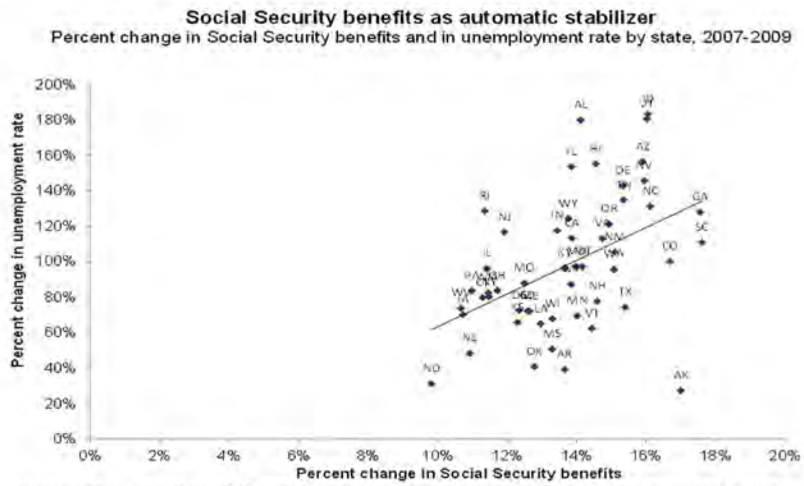
Social Security and defined-benefit pensions have traditionally acted as automatic stabilizers because benefit outlays increase when older workers who lose their jobs during recessions decide to retire and workers in poor health who cannot find jobs apply for disability benefits. Because retirement benefits are adjusted for earlier retirement, an unemployed worker's decision to retire early does not have a large impact on Social Security's finances. However, the drop in payroll tax revenues and increase in disability take-up during the Great Recession did exacerbate Social Security's long-term funding shortfall.

In the last two recessions and weak recoveries, Social Security's helpful countercyclical properties were countered by the procyclical effects of 401(k) plans. Thus, the number of beneficiaries receiving retirement (Old Age and Survivor Insurance) benefits in 2008–2013 was roughly the same as the Social Security actuaries pre-

dicted before the recession, though disability take-up increased (author's analysis of the 2007 and 2013 Social Security Trustees reports).

Nevertheless, Social Security prevented the Great Recession from being worse than it would have been in its absence or if benefits had been cut as part of a fiscal "grand bargain." In a recent working paper, Federal Reserve economists William B. Peterman and Kamila Sommer found that Social Security was very effective at mitigating the effects of the recession, particularly for poorer and older Americans (2014). Likewise, Ghilarducci, *et al.,* (2011) found that Social Security generally has a positive effect on macroeconomic stabilization, while 401(k) plans exhibit a destabilizing effect on the economy.

These two studies use sophisticated models and statistical techniques to estimate the countercyclical effects of Social Security. However, Social Security's role in cushioning the effects of the downturn is also evident from a simple chart, below, showing a statistically significant correlation between the growth in the unemployment and the growth in Social Security benefits by State.



Source: EPI analysis of Social Security *Beneficiaries by State and Zip Code* public data series and Current Population Survey microdata

Social Security is also helpful when the economy faces a chronic demand shortage because it is mostly a pay-as-you go system—redistributing from current workers to current retirees and other beneficiaries—and beneficiaries tend to spend their income more quickly than workers. In comparison, advance-funded pension and savings programs tend to reduce aggregate demand.

What are the major challenges facing Americans in preparing financially for retirement? How well do currently available retirement products, such as IRAs and 401(k)s, meet the needs of consumers? How can they be improved to better meet the needs of today's working families?

401(k)s are an accident of history. In 1980, a benefit consultant working on a cash bonus plan for bankers had the idea of taking advantage of an obscure provision in the tax code passed 2 years earlier clarifying the tax treatment of deferred compensation and adding an employer matching contribution (Sahadi 2001; Tong 2013). Though 401(k)s took off in the early 1980s, Congress did not intend for them to replace traditional pensions as a primary retirement vehicle, and they are poorly designed for this role. Few people have the math skills, financial sophistication, or time to make sense of often conflicting financial advice and make sound investment decisions. IRAs, primarily composed of funds rolled over from 401(k)s, offer even fewer protections and typically have even higher fees (Munnell, *et al.,* 2013).

By limiting the scope for risk pooling and intergenerational risk sharing, the shift from defined-benefit pensions to individual accounts has increased the investment, longevity and inflation risks faced by participants. Individual savers also forgo economies of scale in investment management and administration. As a result, contributions must be nearly twice as high with 401(k)-style plans as traditional pensions to ensure a similar income in retirement (Almeida and Fornia 2008; Morrissey 2009).

Problems caused by the loss of risk pooling are exacerbated by poor decision-making aggravated by a lack of transparency and conflicts of interest. For example, voluntary annuitization introduces adverse selection problems that make it expensive for individuals to hedge longevity risk—a problem aggravated by the difficulty individuals face in navigating tricky annuity markets as well as their tendency to undervalue income streams and underestimate the risk of living well into their 80s or 90s.

Investment risks faced by individual investors are often poorly understood even among supposed experts. Individual investors are often led to believe that bull and bear markets cancel out over time, or that target-date funds shield them from risk. They naively interpret excess returns as a sign of a good investment going forward. They are often lulled into a false sense of security if stock returns are high, fail to rebalance in the wake of rallies, or simply gamble on all-stock portfolios. Risk taking is encouraged by tax subsidies whose value depends on investment earnings, making these particularly ill-suited for lower-income workers, who are rationally more risk-averse. Thus, at the opposite extreme, some individuals choose to invest very conservatively throughout their working lives or lock in low returns by selling in the wake of market downturns.

What role can employers, government, and other parties play to improve retirement security? What specific policies would enhance U.S. retirement security? How are States affected by and working to address retirement security issues?

Our first priority should be expanding Social Security benefits as proposed by Sen. Tom Harkin, Rep. Linda Sanchez, and others. Such measures could replace some of the benefits cut in 1983 and restore the progressivity of lifetime benefits as life expectancy grows more unequal (Morrissey 2013; Waldron 2007). The Harkin-Sanchez bill would also better protect seniors and other beneficiaries from the rising cost of health care and other increases in the cost of living that erode the value of their benefits.

We should also take steps to preserve existing defined-benefit pensions in the public and private sector. Contrary to the conventional wisdom, most public employee pension plans are in reasonable shape despite the effects of the financial crisis. Those that are in the worst shape got that way because elected officials neglected to make actuarially required contributions, so the focus should be on preventing this from happening in the future, not reneging on promises to workers.

Next, we should address some of the worst problems of 401(k)s and IRAs *before* encouraging workers to save more in these plans through auto enrollment and similar measures. The Thrift Savings Plan (TSP) offered to Federal workers is sometimes put forward as a model 401(k)-style plan because fees are kept low by pooling assets and investing in low-cost passively managed funds. Participants have limited investment options and are encouraged to convert savings to a low-cost annuity at retirement (Davis, *et al.,* 2010).

Though the Thrift Savings Plan is an enormous improvement over 401(k)s available to most private-sector workers, it does not resolve the fundamental problems of market risk and upside-down tax subsidies. In addition, TSP lifecycle funds, which may soon become the default investments, are heavily invested in stock, with an equity allocation ranging from 88 to 54 percent during the accumulation phase (author's analysis of FRTIB n.d.).

At the opposite extreme in terms of risk, the MyRA plan proposed by President Obama would invest workers' savings in a Government bond fund similar to the G Fund, the Thrift Savings Plan's current default investment. This low-cost saving vehicle is a convenient and cost-effective way of meeting the needs of the most risk-averse savers, except that account balances must be rolled over to (often high-risk and high-fee) IRAs when they reach $15,000.

Some problems with defined contribution plans may be addressed by making them more like defined benefit pensions. Senator Harkin's USA Retirement Funds, for example, take advantage of risk pooling, economies of scale and professional investment management to provide retirees with secure lifetime incomes. The California Secure Choice Plan is another innovative approach to providing workers who lack access to an employer-based pension with a plan that would shield them from the high costs and risks of 401(k) plans. Neither plan would require employers to take on long-term pension obligations. Another option is the Adjustable Pension Plan, currently awaiting IRS approval, which would reduce, but not eliminate, employers' long-term risks.

Last but not least, we should reconsider our reliance on tax incentives for retirement saving. This approach is inherently inefficient, because there is no way to guarantee that tax subsidies encourage people to save more as opposed to simply

shifting funds to tax-favored accounts. Nevertheless, a refundable tax credit is a more efficient way to encourage voluntary saving than the current system, which actually provides a tax break on investment income.

The Economic Policy Institute's Guaranteed Retirement Account plan proposed converting tax breaks for 401(k)-style plans and IRAs into flat tax credits to offset the cost of new accounts with a modest rate of return guaranteed by the Federal Government. The plan was designed to improve the retirement security of most Americans without costing taxpayers more than the current system (Ghilarducci 2007).

EPI is working on a variation of the original GRA plan that, like the original plan and the Center for American Progress's SAFE retirement plan, would be a pooled and professionally managed fund that uses a gain and loss reserve to stabilize returns credited to notional accounts (Davis and Madland 2013). Specifically, the aim would be to maximize the share of retirees who achieve a target rate of return while minimizing the share with poor outcomes. In contrast to the SAFE plan, the new "GRA 2.0" plan would smooth cumulative rather than annual returns. Unlike the original GRA plan, the Government would not necessarily need to guarantee returns in the "GRA 2.0" model.

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PREPARED STATEMENT OF ROBERT HILTONSMITH

POLICY ANALYST, DEMOS

MARCH 12, 2014

Thank you, Chairman Merkley and Members of the Senate Banking Committee's Subcommittee on Economic Policy for the opportunity to testify today. My name is Robbie Hiltonsmith, Policy Analyst at Demos, a public policy organization working for an America where we all have an equal say in our democracy and an equal chance in our economy. I am happy to be here today to testify on the state of U.S. retirement security, because though retirement security is one of the lynchpins of economic security for the middle class, it is also proving sorely elusive for the majority of Americans. One of the major reasons for this brewing retirement security crisis is the inadequacy and inefficiency of defined contribution plans. These plans, which include 401(k)-type plans and IRAs,[1] are the primary ways for most workers to supplement Social Security retirement income, and it is on the inherent problems with these plans that I will focus my testimony.

According to the National Compensation Survey (NCS), less than two-thirds of all private sector workers in the United States (64 percent) were covered by any workplace retirement plan in 2012, and just 49 percent of all such workers participated in their employer plan.[2] However, the retirement security crisis isn't just limited to the half of workers who don't participate; even many of those who are actively saving for retirement are at risk as well, because most U.S. workers participating in a workplace retirement plan are covered only by an individual-account, 401(k)-type plan. These plans place nearly all of the risk on workers, who face the very real possibilities of losing their savings in a stock market plunge or of outliving their retirement savings. Even worse, 401(k)s often have high, hidden investment management, administration, and trading fees that can eat into their returns, making saving for retirement even more difficult. Though 401(k)s have only become the primary retirement savings vehicle for workers in the past three decades, the inadequacies of these plans are already showing in retirement savings data: nationally, as of 2010, 40 percent of households ages 55–64, the first cohort of workers to be forced to rely on the 401(k), had nothing saved for retirement, and the median retirements savings among those with any was just $100,000.[3] These stark figures, along with many others, show that the fees and risks mean that 401(k)s are make them unsuitable to be U.S. workers' primary supplement to Social Security in retirement.

So, what risks, in particular, does being forced to depend on a 401(k) for the bulk of one's retirement income force workers to shoulder? Retirement experts generally agree that there are five major types of risk that 401(k) participants bear. Savers risk losing their savings to poor investment decisions, which experts term investment risk; high fees and low contributions (contribution risk); or a turbulent market (market risk); they also risk outliving their retirement savings (longevity risk); and being forced to, or unwisely choosing to, withdraw from or borrow against their savings (leakage risk). Though many 401(k) proponents believe the private retirement market can and will mitigate these risks, the continued inadequacy of Americans' retirement savings after nearly three decades of the 401(k) suggest otherwise.

The financial crisis and following recession of the past few years has made the magnitude of the effect of market risk on 401(k) retirement savings crystal clear. During the stock market plunge of 2008 and 2009, 401(k)s and IRAs lost a total of $2 trillion dollars in value, while the average 401(k)-holder lost over ⅓ of his or her savings.[4] Retiring during a market downturn generally means either doing so with vastly reduced retirement savings, which—though retirees' balances may later recover—can certainly affect potential retirees' long- and short-term financial planning, or lead them to postpone retirement, which in turn prevents younger workers from entering the labor force and worsens the already high youth unemployment that accompanies such downturns. Just how large of an impact can market cycles have on 401(k) balances? By our calculations, if an average worker with retirement savings had retired at the height of the last big stock market surge in 2000, he or

[1] I use "401(k)" or "401(k)-type plan" as a shorthand to refer collectively to the many types of similar employer-based individual retirement plans, including 401(k)s, 403(b)s, 457s, and Keoghs.

[2] U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in the United States," March 2013.

[3] Federal Reserve, 2009 Panel Survey of Consumer Finances, *http://www.federalreserve.gov/econresdata/scf/scf_2009p.htm.*

[4] Monique Morrissey, "Toward a Universal, Secure, and Adequate Retirement System", Retirement USA, 2009.

she would have had over 50 percent more to live on during retirement than if she had retired in the depths of the last recession in 2009.

Another problem with 401(k)s is investment risk—the possibility of participants making poor investment decisions. Though the freedom to choose one's own investments is lauded as a benefit of 401(k)s, in fact, most actual Americans are extremely ill-equipped to choose among often inscrutable investment choices. For example, in one study, 84 percent of retirement plan participants thought that higher mutual fund fees guaranteed better performance,[5] even though multiple studies have shown that there is no relationship between the two. 401(k) participants, despite years of advice from their investment advisors, generally have no idea how to balance their portfolios, often adopting an all-or-nothing approach to risk. Twenty-one percent of participants have more than 80 percent of their assets in stocks and other risky assets, far too much for any but young savers. Another 38 percent have none invested in stocks, a far-too-conservative allocation for any age.[6] Individualized investing might seem to conform to our Nation's idealized vision of freedom and individual choice, in reality, leaving the investment decisions up to financial market professionals would result in higher returns and lower risk.

Longevity risk, or the possibility that retirees outlive their retirement savings, is increasingly worrisome as high-income Americans continue to live longer. Though most know that life expectancies are on the rise, it's still impossible to know exactly how long we, individually, will live. When surveyed, individuals, generally, underestimate their own probabilities of living to an old age.[7] 401(k)s, by their very nature, simply provide a fixed sum to live off of in retirement; ensuring that sum lasts the rest of one's life would require exact knowledge of one's exact date of death, a grisly and impossible prospect. Investment options such as annuities, which can mitigate longevity risk, remain both prohibitively expensive and are often extremely complex. The most efficient way to eliminate longevity risk is to pool such risk among a wide swath of the country, similar to the approach taken by the Affordable Care Act. Unfortunately, the structure of the current 401(k) system makes it nearly impossible to do so.

At first blush, the fact that 401(k)s allow account-holders to make early withdrawals or take out loans against account assets to pay for unexpected expenses might seem to be an advantage of such plans, helping individuals to smooth out life's little financial curveballs and potholes. However, the flipside of allowing these early withdrawals/loans are that they present another risk—commonly referred to as leakage risk—to adequate retirement savings. Leakage can significantly damage workers' retirement prospects, particularly those of younger workers, who lose decades of compounded returns when they withdraw, cash out or borrow. According to Vanguard, one of the largest 401(k) providers, 3.7 percent of participants younger than age 60 withdrew an average of 29 percent of their total 401(k) balance in 2010;[8] Even more alarmingly, 18 percent of all 401(k) participants, and 23 percent of all participants with incomes less than $30,000, had a loan outstanding at the end of the year. Ten percent of these loans, Vanguard says, are never repaid, significantly affecting retirement savings, and the interest lost during the loan period reduces account balances for repaid and unpaid loans alike. The GAO estimates that such withdrawals and loans (including between-job cashouts) sapped nearly $84 billion from retirement accounts in 2006, a number which surely rose during the recent recession.[9] Between-job leakage is actually responsible for the lion's share of this leakage, as significant pluralities of workers simply cash out their retirement plans when leaving a job, particularly younger workers. A recent AON study found that 59 percent of Millennials, and 46 percent of Gen Xers, cashed out their 401(k)s each time they changed jobs.[10]

Finally, perhaps the largest 401(k) risk is contribution risk: the risk that workers contribute too little to their retirement over the course of their lifetimes. Workers contribute too little to 401(k)s for three main reasons: either they're simply not earning enough, they don't trust 401(k)s and the financial markets in general, or simply don't have the financial literacy to understand how plans work or how much

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[5] Neil Weinberg and Emily Lambert, "The Great Fund Failure", Forbes, 2003, *http://www.forbes.com/forbes/2003/0915/176_4.html.*

[6] Employee Benefits Research Institute, "401(k) Plan Asset Allocation", 2009.

[7] Teresa Ghilarducci, *When I'm 64: The Plot Against Private Pensions and the Plan to Save Them,* Princeton University Press, p. 124, 2008.

[8] *https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/RetResGreatR.*

[9] Government Accountability Office (GAO), "Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings," 2009, *http://www.gao.gov/products/GAO-09-715.*

[10] *http://www.aon.com/attachments/RetirementReadiness_2010_Report.pdf.*

to contribute. Employees themselves believe the first reason, lack of income, is the also the largest, and decades of stagnant wages would seem to lend credence to their claim. In a 2007 poll, 56 percent of respondents said that the reason they were not saving for retirement was because they couldn't afford to save.[11] Figures on contribution rates by race confirm this claim; those for Latinos and African-Americans, who have lower average incomes, trail significantly behind higher income whites and Asian Americans.[12]

The variety of fees charged by the funds in which 401(k) assets are invested can, too, make it even more difficult to contribute enough to individual retirement accounts. These fees, though often seemingly innocuous single-digit percentages, actually add significantly to the risk that workers are unable to save enough for retirement. According to our research, these fees can actually consume 30 percent or more of the gross (or before-fee) returns earned by savers' investments. Over a lifetime, these fees can add up to a significant chunk of workers' savings. According to our model, fees can cost an average household nearly $155,000, in fees or lost returns, effectively reducing the size of their nest egg by over 30 percent. How are mutual funds able to take such a large cut for their services? Mainstream economic theory provides a simple answer. When consumers of a product, such as mutual funds, do not have enough information or education to choose rationally among competing products, suppliers (funds) can charge higher prices. And that's precisely what happens: undereducated and overworked 401(k)-holders often do not choose wisely amongst the limited menu of often opaque and seemingly identical mutual funds that their 401(k) provides. Employers, too, often lack expertise: employees in charge of many firms' 401(k)s only administer the plans part time, and thus often do not have the knowledge necessary to choose amongst nearly identical 401(k) plans, or the incentive or power to push for a plan switch if their firm's plan is on the higher end of the cost spectrum. And unfortunately, many IRA brokers and 401(k) financial advisors take advantage of this lack of knowledge by pushing higher-fee plans on savers and employers, because they are not required to look out for the best interests of their clients, and are in fact often incentivized to push such high fee plans because they receive part of their compensation from the fees generated by the plans they sell.

Though it has been difficult to quantify the losses due to "excessive" fees, in large part because of the lack of publicly available data on fees charged by 401(k) plans, recent research has shown large losses due to both savers' and plan sponsors' lack of knowledge and poor advice from plan investment advisors. One study estimates that savers lose an average of nearly 1 percent in returns due to poor choices by plan fiduciaries, in part likely due to poor or conflicting advice received from their plan financial advisors.[13] These losses could be partially or entirely mitigated by requiring financial advisors for 401(k)-type plans give advice in their clients' best interest.

The 401(k)'s plethora of risks and excessive fees make a convincing case for what many critics have been saying for decades: this national experiment in 401(k)-based "do-it-yourself-retirement" has been, and will continue to be, a failure. A new system to replace 401(k)s is urgently needed. All hardworking Americans need a safe, low-cost secure account to save for retirement, one that can also provide a lifetime stream of income when they retire; in other words, an account that protects workers from the severe risks and high costs of 401(k)-type plans.

PREPARED STATEMENT OF KRISTI MITCHEM

EXECUTIVE VICE PRESIDENT, STATE STREET GLOBAL ADVISORS

MARCH 12, 2014

Good afternoon Chairman Merkley, Ranking Member Heller and Members of the Subcommittee. Thank you for this opportunity to talk about retirement security and the critical impact it plays in our economy.

My name is Kristi Mitchem. I am an Executive Vice President for State Street Global Advisors, the investment management arm of State Street Bank and Trust Company. State Street Global Advisors is a leading asset management firm, en-

[11] The Rockefeller Foundation, "American Worker Survey: Complete Results," 2007, *http://www.rockefellerfoundation.org/uploads/files/1f190413-0800-4046-9200-084d05d5ea71-american.pdf*.

[12] Ariel/Hewitt, "401(k) Plans In Living Color," 2009, *http://www.arielinvestments.com/content/view/1223/1173/*.

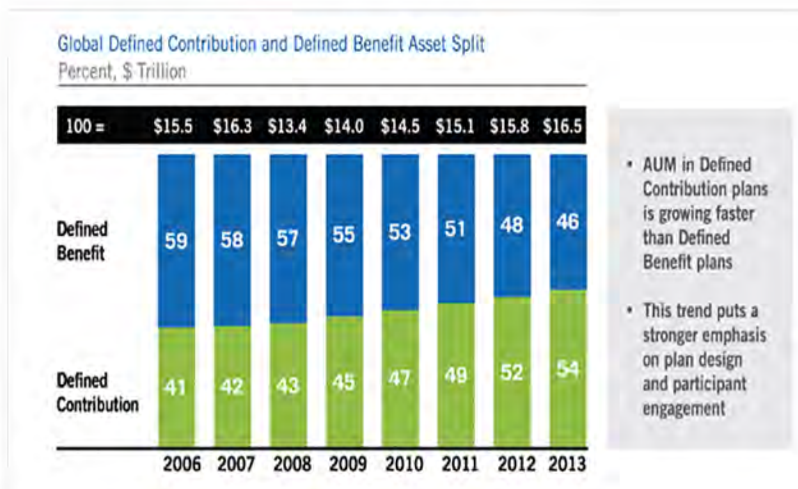
[13] Quinn Curtis and Ian Ayres, "Measuring Fiduciary and Investor Losses in 401(k) Plans," February 2014.

trusted with over $2.3 trillion in assets under management.[1] Importantly, State Street Global Advisors is one of the largest providers of defined contribution (DC) services worldwide, managing more than $305 billion in retirement plan assets on behalf of employers and retirement plan participants. Our size and penetration within the DC marketplace affords me the opportunity to interact with U.S. DC plan sponsors on a regular basis, informing my perspective.

Having worked with retirement plan sponsors for a decade, I recognize the important role that employers can play in assisting workers with retirement preparation. My objective today is to highlight the success that the largest employers in the United States have had in helping their workers achieve retirement adequacy and to suggest ways in which we can make this success more universal by removing barriers that currently prevent many smaller companies from offering well-structured retirement savings programs.

Retirement Today

For nearly 50 years, the retirement landscape was dominated by defined benefit (DB) plans, which provided many Americans with a monthly lifetime pension. But in more recent decades, the number of Americans covered by DB plans has diminished substantially. We have shifted to a system that is much more dependent on self-funded DC plans. By year-end 2013, DC plans were more prevalent than DB plans in the United States, as well as globally. This trend is likely to continue as plan sponsors increasingly look to reduce their pension liabilities.



Source: McKinsey Retirement Practice; Estimated figures, 2010.

DC plans are now the primary source of retirement benefits for millions of Americans. We believe these plans have the potential to provide retirement security to the majority of American workers. However, realizing this potential will require substantial progress from where we are today. We recognize and applaud regulators and legislators for acknowledging the existing issues around access, participation and cost.

In developing solutions to these problems it may be useful to consider how and where we are having success in retirement preparation today. Specifically, we believe that many of the largest and most sophisticated plans in the United States have designed and implemented adequate, self-funded retirement plans. The challenge we face is determining the public policy shifts necessary to close the gap between large and small employers with regard to DC plan provision and structure.

[1] As of December 31, 2013.

The "Great Divide"

When it comes to retirement planning and preparation, we believe the "Great Divide" is more around employer size than employee income level. Large employers are much more likely to provide a retirement plan. And when they do, the plan produces better results for those employees that participate in it. Comparing data from large and small plans across a number of dimensions illustrates the impact of employer size on retirement readiness.

- Access: 89 percent of large companies offer DC plans;[2] however only 14 percent of small employers sponsor some type of plan for their employees to save for retirement.[3]
- Participation Rate: The average participation rate in the largest plan segment is close to 80 percent. For the smallest companies that offer a plan, participation rates dip down to 74.2 percent.[4]
- Savings Rates: In the largest plans, the average savings rate is 7.3 percent while for the smallest plans it is 5.6 percent.[5]
- Account Balances: The average account balance in the largest plans is about two times the average across all plan sizes—$140,000 compared to $63,878.[6]

DC Advances within the Large Plan Market

The largest plan sponsors are clearly outpacing small employers in the race to provide a viable replacement for DB plans; the question then becomes why have they been able to create more successful defined contribution offerings.

The answer in my view lies in the fact that the largest plans in the United States are leveraging changes in public policy and incorporating insights from behavioral finance to drive real improvements in retirement readiness. Specifically, they are taking the following actions to automate good behaviors, simplify choices and enhance transparency:

- Automatically enrolling new employees.
- Automatically increasing contribution rates for participants over time.

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[2] Bureau of Labor Statistics.

[3] GAO Study on Challenges and Prospects of Employees of Small Businesses, July 16, 2013.

[4] PLANSPONSOR DC Survey 2013.

[5] *Ibid.*

[6] Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of the 'All-In' Fee 2011. Deloitte.

- Offering their participants a more streamlined and simplified menu of investment choices to help participants make better investment choices.
- Embracing well-diversified target date funds as default investment options to aid participants in managing key investment risks.
- Negotiating lower investment fees on behalf of participants across all types of investments and asset classes.
- Utilizing high-quality, low-fee index based investments where appropriate on retirement plan investment menus.

Comparing Characteristics of Smaller and Larger Plans

Comparing Characteristics of Smaller and Larger Plans

DC PLAN FEATURES	MICRO <$5MM	SMALL $5MM-$50MM	MID 50MM-$200MM	LARGE $200MM-$1B	MEGA $1B+
Auto-enrollment	23.4%	43.1%	55.5%	57.3%	61.4%
Participation Rate	74.2%	77.7%	78.6%	77.9%	80.1%
Deferral Rate	5.6%	6.0%	6.3%	6.7%	7.3%
Auto-escalation	12.1%	26.2%	38.3%	46.6%	54.2%
Target Date Fund Usage	58.9%	74.0%	78.1%	81.8%	84.8%
Use of Collective Investment Trusts (CITs)	7.3%	8.8%	14.4%	27.8%	50.7%
Average Expense Ratio of 0.25-0.50% (25-50 bps)	10.6%	14.9%	19.6%	32.1%	45.3%

Source: PLANSPONSOR DC Survey 2013.

Helping Small Employers Increase Plan Sponsorship

So how do we translate the successful evolution of DC plans sponsored by large employers into success for the small employer market? First, we must remove current obstacles that make plan sponsorship more challenging for small employers. Unlike large employers, small businesses often do not have the time, resources and expertise to administer a retirement plan. The administrative burdens and fiduciary responsibilities associated with plan sponsorship can be overwhelming and inhibit adoption.

We believe that if smaller companies could have access to a multiple-employer plan (MEP) through an industry group or other association, they would be more likely to offer a workplace retirement plan. We would therefore suggest that you consider changes to current policy that would support the growth of multiple-employer DC plans. Specifically, we would recommend that: 1) the current DOL nexus requirement be eliminated for participant-funded retirement programs, and; 2) a safe harbor be offered to participating members of a multiple-employer DC plan, provided that certain best-in-class plan design features are incorporated. Developing and encouraging the use of MEPs would reduce the barriers to plan adoption among small companies by spreading administrative and personnel related costs across a number of employers. Importantly, it would also help smaller plans achieve the kind of fee leverage that larger plans now enjoy. In other words, access to MEPs would make retirement plan provision more attractive to small employers and allow participants in these plans to keep more of what they save through lower plan expenses.

A Future Model for Small Employers

As discussed above, we believe one potential way to close the gap between large and small plans would be to create a safe harbor for employers that participate in

well-structured, multiple-employer DC plans. These well-structured MEPs should mimic the largest plans in the United States by leveraging automation and simplification to drive better participant outcomes. In our view, the features required for safe harbor coverage should include:

- Auto enrollment starting at a minimum of 6 percent with default into an indexed target date fund.
- Automatic contribution rate escalation at a minimum of 1 percent annually up to a cap of 15 percent.
- A simplified investment menu including an index target date fund, a limited number of core options and a lifetime income option to help manage longevity risk.
- A loan program available only for hardship to prevent plan leakage.
- A total plan expense ratio under a certain limit based on the size of the MEP.
- An optional employer match or discretionary profit-sharing type contribution.

In order to make participation in MEPs easier and more attractive, we believe the following additional changes in public policy should also be considered:

- Removal of testing and reporting requirements for employers under a certain size.
- Acceptance of aggregated 5500-type reporting with a breakdown of contribution amounts by participating employers.
- Alterations to the tax code to prevent disqualification of a multiple-employer plan despite a violation by one or more participating members.

We believe granting small businesses the ability to participate in simplified MEPs would send an important signal to the retirement market. This change would inspire DC plan service providers and investment managers to create more products tailored to small businesses, providing a broader range of choices and greater economies of scale to an underserved market segment.

Are Large Plan Advancements Sufficient?

In the sections above we explored the differences between large and small plans and suggested potential ways to replicate the large plan experience in the small plan market. One critical question that we have not explicitly addressed, however, is whether or not well-structured plans, such as those currently prevalent at the larger end of the market, are capable of delivering retirement security to the middle class. In order to answer this question, we look to data produced by the Employee Benefit Research Institute (EBRI). In December of 2013,[7] EBRI's Retirement Security Projection Model (RSPM) analyzed the potential of DC plans to produce "adequate" income replacement for retirement. EBRI data shows that when plans adopt automatic enrollment and auto escalation, retirement adequacy rates are high. According to EBRI, 85 percent to 90 percent of younger middle class workers participating in plans with auto features are expected to replace 80 percent of their income in retirement.[8] Importantly, lower income quartiles also do well under the auto feature condition, with 90 percent of lower income workers expected to replace 80 percent of their preretirement income.

Despite these encouraging statistics, there is more that plan sponsors can and should do to improve the retirement prospects of those with fewer years to retirement and to provide a buffer for newer employees. In our view, two of the most impactful steps that plan sponsors could take to further increase retirement adequacy would be to utilize more aggressive defaults and incorporate lifetime income options in their plan menus.

[7] EBRI Retirement Security Project Model findings from EBRI/Jack Vanderhei testimony to the U.S. Senate Committee on Finance, Subcommittee on Social Security, Pensions, and Family Policy, Hearing on Retirement Savings for Low-Income Workers. Statement of record, Wednesday, February 26, 2014.

[8] EBRI Assumptions: " . . . assuming current Social Security benefits are not reduced, 86 percent of workers in the lowest-income quartile with more than 30 years of eligibility in a voluntary enrollment 401(k) plan are simulated to have sufficient 401(k) accumulations that, when combined with Social Security retirement benefits, would be able to replace at least 60 percent of their age 64 wages and salary on an inflation-adjusted basis. When the threshold for a successful retirement financing is increased to 70 percent replacement, 76 percent of these workers will still meet the threshold, based solely on the combination of projected 401(k) savings and Social Security combined. At an 80 percent replacement rate, 69 percent of the lowest-income quartile will still meet the threshold. It should be noted, however, that the percentage of those in the highest-income quartile deemed to be "successful" from just these two retirement components drops to 59 percent from 83 percent when measured against the 60 percent threshold."

EBRI and other industry associations, such as the Defined Contribution Institutional Investment Association (DCIIA), have done extensive research in the area of defaults and demonstrated the strong relationship between initial deferral rates and retirement adequacy. Because many employees will "stick" at the default rate, it is important for plan sponsors to choose default savings rates that are high enough to provide for adequate savings. Increasing the default savings rates from 3 percent to 6 percent can impact accumulated balances substantially.[9] If we double the savings rates of 45-year-old middle-class workers, their accumulated balances at retirement would grow by 41 percent.[10]

The provision of lifetime income is another key enabler of retirement success because investors in these types of strategies benefit from managing longevity risk. In DC plans where a lifetime income product is not offered, participants are required to generate enough savings within their personal retirement plan accounts to support themselves in the event that they live well past the average life expectancy (age 82). Investors in lifetime income products transfer the risk of outliving their assets to an insurer who, by pooling many individuals together, can manage to the mean life expectancy rather than the outer bounds of longevity. The broad adoption and usage of retirement income products in the United States would materially increase the probability of success for many savers by decreasing the accumulated savings needed to achieve adequacy by approximately 20 percent.[11]

The Voice of the Participant

One very important voice, which we have not considered as part of our testimony up to this point, is the voice of the participant—the employee who is or will participate in a workplace savings plan. If participants tolerate but do not accept automation, it is unlikely to have lasting impact. Further, if income options are offered but not embraced, participants will not experience the benefits of longevity hedging. At State Street Global Advisors, we regularly survey participants on their attitudes toward a range of issues and have explored both of these questions. The good news is, our survey results have shown that Americans want to save for retirement, believe in automation and would like to see lifetime income strategies incorporated into DC investment menus.

Highlights from State Street Global Advisors Participant Surveys

In our 2011 DC Investor Survey, we found:

- On average participants thought that they should be saving approximately 14 percent of their pre-tax wages in a retirement plan.
- 74 percent of participants surveyed indicated that they wanted their employer to automatically make them do something to prepare for retirement.

In our 2012 DC Investor Survey, there was a similar desire for higher savings rates and automation.

- More than half of participants surveyed indicated they would increase their savings up to 10 percent or more if automatically increased by 1 percent a year.

With regard to income strategies, our 2013 DC Investor Survey showed the increasing need for addressing the decumulation phase of retirement.

- Over 60 percent of those surveyed said they plan to take monthly withdrawals.
- 7 out of 10 recognize they will need an additional source of guaranteed income in retirement, separate from Social Security.

Concluding Comments

One of the unique facets of the U.S. retirement system is that the employer plays a central role in helping individuals to plan and save for retirement. What may not always be well understood, however, is that this workforce-centered design actually

[9] DCIIA: The Impact of Auto-Enrollment and Automatic Contribution Escalation on Retirement Income Adequacy, Jack VanDerhei, Employee Benefit Research Institute, and Lori Lucas, Callan Associates. Also see EBRI September 2012 Notes, Vol. 33, No. 0, "Increasing Default Defferral rates in Automatic Enrollment 401(k) Plans: The impact of retirement saving success in plans with automatic escalation," p. 12.

[10] Based on SSgA assumptions: beginning saving at age 25 at 3 percent per annum, increase of savings to 6 percent per annum at age 45. Contributions are made annually with a static return of 5 percent per annum and wage growth estimated at 3 percent per annum.

[11] SSgA calculation comparing the present value of a cash flow from age 65 to the 90 percent joint survivor age (98) to the present value of a mortality weighted joint survivor cash flow from 65 until death. Mortality assumptions based on Social Security cohort life table for birth year 1950 and cash flows discounted by the Treasury yield curve from 3/3/14.

motivates savings in individuals who otherwise would not contribute. A recent research piece by Holden and Bass (2013) reports that half of DC participants strongly or somewhat agree with the statement "I probably wouldn't save for retirement if I didn't have a retirement plan at work." And for those with a household income of less than $50,000 a year, that response rate increases to nearly 70 percent.

Given the important role that employers play in enabling retirement savings, it is only natural that any exploration of how to improve the system begin with an examination of why certain employers are achieving success and others are not. In our view, the dominant explanatory variable is plan size. We have presented solid evidence that the largest employers in the world are creating plans that work by incorporating auto features and using their size and scale to drive down costs. We believe the next step in the evolution of DC plans should be to bring aspects of that model to a wider range of plan sponsors. In our view, this can be accomplished in part by supporting the creation of well-structured multiple-employer DC plans.

Thank you again for the opportunity to testify on the importance of ensuring retirement security for America's middle class. I welcome any questions you may have.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

T-177

United States Senate Committee on Banking, Housing & Urban Affairs

SUBCOMMITTEE ON ECONOMIC POLICY

Hearing on:

THE STATE OF U.S. RETIREMENT SECURITY: CAN THE MIDDLE CLASS AFFORD TO RETIRE?

Wednesday, March 12, 2014, 2:30 PM – 4:30 PM
538 Dirksen Senate Office Building

Statement for the Record

Jack VanDerhei, Ph.D.
Research Director
Employee Benefit Research Institute (EBRI)

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THE STATE OF U.S. RETIREMENT SECURITY: CAN THE MIDDLE CLASS AFFORD TO RETIRE?

By Jack VanDerhei, Ph.D.
Research Director, Employee Benefit Research Institute (EBRI)

1 Introduction

Measuring retirement savings and retirement income adequacy for low-income workers is an extremely important and complex topic, and EBRI started to provide this type of measurement in the late 1990s with the development of the EBRI Retirement Security Projection Model® (RSPM).[1] When we most recently modeled the projected outcomes for Baby Boomers and Gen Xers in 2014, we found that between 57 percent and 59 percent were expected to have adequate retirement income to fund 100 percent of simulated basic retirement expenses (housing, food, etc.—plus uninsured health care costs, using EBRI's Retirement Readiness Ratings™ (RRRs) as the gauge). Some retirement planners suggest that many households are able to successfully cut expenditures below the average expenses when financially constrained. Therefore, we also computed thresholds of 80 and 90 percent of simulated expenses and on that basis found that the RRRs for Baby Boomers and GenXers at a 90 percent threshold was between 67 and 70 percent. When the threshold was further relaxed to an 80 percent threshold, the RRRs increased to 81–84 percent.[2]

Who is most at risk of not having adequate retirement income? Not surprisingly, lower-income households have much lower RRRs: The 2014 baseline RRRs range from 17 percent for the lowest-income[3] households to 86 percent for the highest-income households with a 100 percent of simulated expenses threshold. The middle class (defined as those in the second and third income quartile for purposes of this statement) had an RRR of 62 percent. At a 90 percent threshold, the RRR for middle class households increases to 74 percent (indicating that nearly 3 in 4 of those households would have sufficient financial resources to cover 90 percent of simulated basic retirement expenses, as detailed above). At an 80 percent threshold, 88 percent of the middle class households are predicted to have sufficient retirement income.

However, it should be noted that these probabilities will depend to a large extent on whether future years of employment take place with employers sponsoring defined contribution retirement plans or not. Previous EBRI analysis[4] shows the positive impact of future years of eligibility for a defined contribution plan. For GenXers[5] in the middle class with no future years of eligibility in a defined contribution plan, the RRR value when measured with a 100 percent of simulated expense threshold is 51 percent—indicating that almost ½ of this cohort are projected to run short of money in retirement. This value increases to 56 percent for those in the middle class with one to nine future years of eligibility in a defined contribution plan. The RRR value increases further to 71 percent for those in this category who have 10–19 future years of eligibility in a defined contribution plan, and reaches a maximum value of 80 percent for those with 20 or more future years of eligibility in a defined contribution plan. When the threshold for a successful retirement is measured at a 90 percent of simulated expense threshold, the RRRs range from 62 percent for those with no future years of eligibility to 88 percent for those with 20 or more years. At an 80 percent of simulated expense threshold, the RRRs range from 79 for those with no future years of eligibility to 96 percent for those with 20 or more years.

2 The Potential of 401(k) Plans to Produce Adequate Income Replacement for Middle Class Workers

The EBRI/ICI 401(k) database has been used to provide annual reports based on actual account balances of large cross sections of 401(k) plan participants since 1996.[6] Looking at consistent participants in the EBRI/ICI 401(k) database in the wake of the financial crisis (over the four-year period from year-end

2007 to year-end 2011), a joint EBRI/Investment Company Institute (ICI) analysis found that the average 401(k) account balance fell 34.8 percent in 2008, then rose from 2009 to 2011.[7] Overall, the average account balance in this consistent sample increased at a compound, annual, average growth rate of 5.4 percent over the 2007–2011 period.

While this information is certainly useful to evaluate assertions (and anecdotal claims) with respect to 401(k) plans, it needs to be supplemented with simulation modeling for a proper assessment of the potential of 401(k) plans to produce "adequate" income replacement for several reasons:

- The EBRI/ICI 401(k) database does not contain information on individual retirement account (IRA) rollovers, many of which may have originated as a 401(k) balance at an individual's prior employer(s), and therefore may only provide information on a fraction of the participant's retirement accumulations if there have been one or more job changes in their careers.
- Even if one looks only at 401(k) participants who are on the verge of retirement and have had significant tenure with the current employer, there is a significant likelihood that they would not have been eligible to participate in a 401(k) plan during their entire career with the current employer.[8]
- Since the passage of the Pension Protection Act of 2006, many of the 401(k) plans that had previously allowed eligible employees to voluntarily enroll have been modified to automatically enroll eligible employees. Although these employees will have the ability to opt out of such participation, it is clear that these plans have had a substantial impact on participation rates, especially for lower-income employees.[9]
- An analysis based solely on current balances will, of necessity, not be able to assess the impact of future employee activity (such as potential cash-out behavior at job change) nor the impact of future financial market returns.

In an attempt to assist the Senate Finance Subcommittee on Social Security, Pensions, and Family Policy in its evaluation of the role of 401(k) plans, in December of 2013, EBRI's RSPM was used to analyze the potential of 401(k) plans to produce "adequate" income replacement for retirement.[10] That undertaking found that, assuming current Social Security benefits are not reduced, 84 percent of middle class workers with more than 30 years of eligibility in a voluntary enrollment 401(k) plan are simulated to have sufficient 401(k) accumulations that, when combined with Social Security retirement benefits, would be able to replace at least 60 percent of their age 64 wages and salary on an inflation-adjusted basis. When the threshold for a successful retirement financing is increased to 70 percent replacement, 75 percent of these workers will still meet the threshold, based solely on the combination of projected 401(k) savings and Social Security combined. At an 80 percent replacement rate, 62 percent of the middle class will still meet the threshold.

When the same analysis is conducted for automatic enrollment 401(k) plans (with an annual 1 percent automatic escalation provision and empirically derived opt-outs), the probability of success for middle class workers with more than 30 years of eligibility increases substantially: 92 percent at a 60 percent threshold; 87 percent at a 70 percent replacement and 81 percent at an 80 percent threshold are assumed to have sufficient resources at those levels.

Note, however, that the analysis of automatic enrollment plans mentioned above used the actual plan-specific default contribution rates (typically 3 percent of compensation). Many have questioned the wisdom of continuing to set the rates at this relatively low level in view of recent empirical evidence suggesting that higher default contribution rates may not result in a substantial increase in opt-out rates. A 2012 EBRI publication[11] simulated the impact of increasing the current plan-specific default rates to 6 percent. Under a set of specified behavioral assumptions, more than a quarter of those in the lowest-

income quartile who had previously NOT been projected to have a financially successful retirement under actual default contribution rates were found to be successful as a result of the increase in default deferral percentage. When employees in the highest-income quartile were analyzed under the same set of assumptions, the percentage of those who had NOT previously been successful (under the actual default contribution rates) that now ARE successful as a result of the change in deferral rate was 18.4 percent.[12]

3 What are the Primary Risks for Middle Class Workers After Retirement?

While the probabilities of not running short of money in retirement for middle class Baby Boomer or Gen Xer is 62 percent when a threshold of 100 percent of simulated expenses is used, 74 percent with a 90 percent threshold, and 88 percent with an 80 percent threshold, it should be noted that these are averages for households in these cohorts, and the actual results may differ markedly, depending on how various risk contingencies play out after retirement. In 2006, EBRI provided a detailed analysis of the replacement-rate levels required to provide retirees with various probabilities of having "sufficient" retirement income.[13] As part of the analysis, a "building block" approach was adopted where the risks of investment, longevity and long-term health care costs were added in incremental layers. The impact of two of these risks are analyzed below.[14]

3.1 Longevity Risk

In an attempt to assess the impact of longevity on retirement income adequacy, relative longevity quartiles were established based on family status, gender, and age cohort. It should be noted that the impact would not be as severe if all retirement income was taken in the form of an annuity (either as a real annuity such as Social Security, or a nominal annuity such as that offered by private-sector defined benefit plans); however, given that only a very small percentage of defined contribution and IRA balances are currently annuitized (and that an increasing percentage of defined benefit accruals are taken as lump-sum distributions when the option is available), the prospect of "out-living" their retirement wealth is a very real risk for many middle class Baby Boomers and Gen Xers.

Figure 1 shows the impact of relative longevity quartiles on 2014 RRRs for the middle class. For middle class households simulated to die in the earliest relative longevity quartile, the RRR with a 100 percent expenditure threshold is 90.3 percent. This value decreases to 72.6 percent in the second relative longevity quartile and 45.3 percent in the third relative longevity quartile. For the middle class households with the longest relative longevity, the RRR falls all the way to 32.6 percent. Similar influences are found when less rigorous thresholds are used. With a 90 percent of simulated expense threshold, the RRR for the earliest relative longevity quartile is 94.5 percent decreasing to only 51.3 percent for those with the longest relative longevity. At the 80 percent threshold, 97.4 percent of those in the earliest quartile having sufficient retirement income decreasing to only 78.3 percent of those in the latest (longest-living) quartile.

3.2 Long-Term Care Risk

One of the primary findings of a 2012 EBRI publication on retirement income adequacy[15] was the significant impact of stochastic health care costs on overall retirement income adequacy. These include health care costs in retirement that are not likely to occur every year (in fact they may never occur for many households), but when they do they may have a catastrophic financial impact, due to their relatively high daily cost and/or potentially long duration. Unlike many other retirement projection models, RSPM has explicitly included the costs of nursing home and home health care costs in its decumulation model since its initial release in 2003 to account for these contingencies.

Figure 2 filters out those simulated life-paths with no stochastic health care costs in retirement and categorizes those costs into quartiles (based on the present value at age 65 of the per capita stochastic health care costs in 2014 dollars). Assuming a threshold of 100 percent coverage of simulated expenses, the results for the middle class show that for this group of families unfortunate enough to experience the highest quartile of stochastic health care costs, the probability of not running short of money in retirement

is 17.1 percent. Not surprisingly, those in the middle class who experience the lowest quartile of stochastic health care costs have a much higher probability of having enough money, with an RRR value of 89.1 percent. At a 90 percent expense threshold, 96.6 percent of the households in the bottom quartile of stochastic health care costs have adequate retirement income, but those in the top quartile have approximately a 1 in 3 chance of running short of money (an RRR of 33.6 percent). At an 80 percent expense threshold, the RRR for households in the bottom quartile of stochastic health care costs jumps to 99.6 percent while those in the top quartile increase only to 64.2 percent.

4 Results for Length of Time Until the Household Runs Short of Money

In addition to information with respect to the percentage of the population that will run short of money in retirement, the distribution of the likely number of years before this takes place has been a major topic of concern. Figures 3 through 5 provide this type of information for the Early Boomer and Gen Xer generations for the middle class. This analysis is more complicated than a simple computation of when individuals or families run short of *retirement income* (which in most cases will be never, due to lifetime Social Security benefits). Instead, an individual or family is considered to "run short of money" in this version of the model if their aggregate resources in retirement are not sufficient to meet aggregate average retirement expenditures—defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid).

Figure 3 shows the distribution of how long retirement money will last for Early Boomers and Gen Xers in the middle class (assuming retirement at age 65). For example:

- After 10 years of retirement, 13 percent of those in the middle class are assumed to have run short of money
- After 20 years of retirement, 29 percent of those in the middle class are assumed to have run short of money
- A total of 38 percent of Early Boomers and Gen Xers in the middle class who retire at age 65 would eventually run short of money while they were still alive.

Figure 4 shows the distribution of how long retirement money will last for Early Boomers and Gen Xers in the middle class (assuming retirement at age 65) by relative longevity quartile. For example:

- After 10 years of retirement, 10 percent of those in the earliest longevity quartile class are assumed to have run short of money compared to 14 percent of those in the latest longevity quartile.
- After 20 years of retirement, 11 percent of those in the earliest longevity quartile class are assumed to have run short of money compared to 42 percent of those in the latest longevity quartile.

Figure 5 shows the distribution of how long retirement money will last for Early Boomers and Gen Xers in the middle class (assuming retirement at age 65) by quartile of stochastic health care cost after filtering out those simulated life-paths with no stochastic health care costs in retirement. For example:

- After 10 years of retirement, 8 percent of those in the lowest stochastic health care cost quartile are assumed to have run short of money compared to 21 percent of those in the highest stochastic health care cost quartile.
- After 20 years of retirement, 11 percent of those in the lowest stochastic health care cost quartile are assumed to have run short of money compared to 59 percent of those in the highest stochastic health care cost quartile.

5 Summary

Since 2003, EBRI research has analyzed the retirement savings and retirement income adequacy of middle class Baby Boomers and Gen Xers in the United States. This statement highlights those previous results and provides new evidence on the importance of proper risk management techniques as a growing number of middle class workers approach retirement age. It would appear that while RRR values depend to a large degree on a household's future years of eligibility in a defined contribution plan (as well as whether future Social Security retirement benefits are reduced)[16], a great deal of the variability in these values could be mitigated by appropriate risk-management techniques at or near retirement age.

For example, the annuitization of a portion of the defined contribution and IRA balances may substantially increase the probability of not running short of money throughout retirement (VanDerhei, September 2006 and Park, 2011). Moreover, a well-functioning market in long-term care insurance would appear to provide an extremely useful technique to help limit the financial volatility from the stochastic, long-term health care risk, especially for those in the middle class.

EBRI looks forward to assisting the members of the Subcommittee as they continue their investigations into this extremely important public policy topic.

Appendix A: Brief Chronology of the EBRI Retirement Security Projection Model®

- The Retirement Security Projection Model® (RSPM) grew out of a multi-year project to analyze the future economic well-being of the retired population at the state level. The Employee Benefit Research Institute (EBRI) and the Milbank Memorial Fund, working with the office of the governor of Oregon, set out in the late 1990s to see if this situation could be evaluated for the state. The resulting analysis (VanDerhei and Copeland, September 2001) focused primarily on simulated retirement wealth with a comparison to ad hoc thresholds for retirement expenditures.
- The April 2001 *EBRI Issue Brief* (VanDerhei and Copeland, April 2001) highlighted the changes in private pension plan participation for defined benefit (DB) and defined contribution (DC) plans and used the model to quantify how much the importance of individual-account plans was expected to increase because of these changes.
- With the assistance of the Kansas Insurance Department, EBRI was able to create the EBRI Retirement Readiness Rating™ (RRR) based on a full stochastic decumulation model that took into account the household's longevity risk, post-retirement investment risk, and exposure to long-term nursing-home and home-health-care risks. The first state-level RSPM results were presented to the Kansas' Long-Term Care Services Task Force on July 11, 2002 (VanDerhei and Copeland, July 2002), and the results of the Massachusetts study were presented on Dec. 1, 2002 (VanDerhei and Copeland, December 2002).
- RSPM was expanded to a national model—the first national, micro-simulation, retirement-income-adequacy model, built in part from administrative 401(k) data. The initial results were presented at the EBRI December 2003 policy forum (VanDerhei and Copeland, 2003).
- The basic model was subsequently modified for testimony for the Senate Special Committee on Aging to quantify the beneficial impact of a mandatory contribution of 5 percent of compensation. (VanDerhei, January 2004).
- The model was enhanced to allow an analysis of the impact of annuitizing defined contribution and individual retirement account (IRA) balances at retirement age (VanDerhei and Copeland, 2004).
- Additional refinements were introduced to evaluate the impact of purchasing long-term care insurance on retirement income adequacy (VanDerhei, 2005).
- The model was used to evaluate the impact of defined benefit freezes on participants by simulating the minimum employer-contribution rate that would be needed to financially indemnify the

employees for the reduction in their expected retirement income under various rate-of-return assumptions (VanDerhei, March 2006).

- Later that year, an updated version of the model was developed to enhance the EBRI interactive Ballpark EStimate® by providing Monte Carlo simulations of the replacement rates needed for specific probabilities of retirement income adequacy under alternative-risk-management treatments (VanDerhei, September 2006).
- RSPM was significantly enhanced for the May 2008 EBRI policy forum by allowing automatic enrollment of 401(k) participants with the potential for automatic escalation of contributions to be included (VanDerhei and Copeland, 2008).
- Additional modifications were added for a Pension Research Council presentation that involved a "winners/losers" analysis of defined benefit freezes and the enhanced employer contributions provided to defined contribution plans at the time the defined benefit plans were frozen (Copeland and VanDerhei, 2010).
- Also in 2009, a new subroutine was added to allow simulations of various styles of target-date funds for a comparison with participant-directed investments (VanDerhei, June 2009).
- In April 2010, the model was completely re-parameterized with 401(k)-plan design parameters for sponsors that had adopted automatic-enrollment provisions (VanDerhei, April 2010).
- A completely updated version of the national model was produced for the May 2010 EBRI Policy Forum and used in the July 2010 *EBRI Issue Brief* (VanDerhei and Copeland, 2010).
- The new model was used to analyze how eligibility for participation in a defined contribution plan impacts retirement income adequacy in September 2010 (VanDerhei, September 2010), and was later used to compute Retirement Savings Shortfalls (RSS) for Baby Boomers and Generation Xers in October 2010 (VanDerhei, October 2010a).
- In October testimony before the Senate Health, Education, Labor and Pensions Committee on "The Wobbly Stool: Retirement (In)security in America," the model was used to analyze the relative importance of employer-provided retirement benefits and Social Security (VanDerhei, October 2010b).
- The November 2010 *EBRI Issue Brief* expanded upon earlier work by EBRI to provide the first results of a new simulation model that estimated the impact of changing 401(k) plan design variables and assumptions on retirement income adequacy. Until recently however, there was extremely limited evidence on the impact of automatic contribution escalation (VanDerhei and Lucas, 2010).
- In February 2011, the model was used to analyze the impact of the 2008–2009 crisis in the financial and real estate markets on retirement income adequacy (VanDerhei, February 2011).
- An April 2011 article introduced a new method of analyzing the results from RSPM (VanDerhei, April 2011). Rather than simply computing an overall percentage of the simulated life-paths in a particular cohort that would not have sufficient retirement income to pay for the simulated expenses, the new method computed the percentage of households that would meet that requirement more than a specified percentage of times in the simulation.
- As explored in the June 2011 *EBRI Issue Brief*, RSPM allowed retirement income adequacy to be assessed at retirement ages later than 65 (VanDerhei and Copeland, June 2011).
- In a July 2011 *EBRI Notes* article (VanDerhei, July 2011), RSPM was used to provide preliminary evidence of the impact of the "20/20 caps" on projected retirement accumulations proposed by the National Commission on Fiscal Responsibility and Reform.
- The August 2011 *EBRI Notes* article (VanDerhei, August 2011) used RSPM to analyze the impact of defined benefit plans in achieving retirement income adequacy for Baby Boomers and Gen Xers.
- In September, it was used to support testimony before the Senate Finance Committee (VanDerhei, September 2011) in analyzing the potential impact of various types of tax-reform options on

retirement income. This was expanded in the November 2011 *EBRI Issue Brief* (VanDerhei, November 2011).

- A March 2012 *EBRI Notes* article (VanDerhei, March 2012) used new survey results to update the analysis of the potential impact of various types of tax-reform options on retirement income.
- The May 2012 *EBRI Notes* article (VanDerhei, May 2012) provided 2012 updates for the previously published RRRs as well as the RSS.
- The June 2012 *EBRI Notes* article (VanDerhei, June 2012) introduced severity categories in the RSS projections for Gen Xers.
- The August 2012 *EBRI Notes* article (VanDerhei, August 2012) provided additional evidence on whether deferring retirement to age 70 would provide retirement income adequacy for the vast majority of Baby Boomers and Gen Xers.
- The September 2012 *EBRI Notes* article (VanDerhei, September 2012) analyzed the impact of increasing the default-contribution rate for automatic enrollment 401(k) plans with automatic escalation of contributions.
- The November 2012 *EBRI Notes* article (VanDerhei, November 2012) reclassified the RRRs to provide additional information on those substantially above the threshold; close to the threshold; and substantially below the threshold.
- The March 2013 *EBRI Notes* article (VanDerhei and Adams, March 2013) used a modified version of RSPM to assess the probability that respondent households would not run short of money in retirement if they did, in fact, accumulate the amount they said would be required in the 2013 Retirement Confidence Survey.
- The June 2013 *EBRI Issue Brief* (VanDerhei, June 2013a) used RSPM to provide a direct comparison of the likely benefits under specific types of DC and DB retirement plans.
- The June 2013 *EBRI Notes* article (VanDerhei, June 2013b) used RSPM to show that 25–27 percent of Baby Boomers and Gen Xers who would have had adequate retirement income under return assumptions based on historical averages were simulated to end up running short of money in retirement if today's historically low interest rates were assumed to be a permanent condition.
- The August 2013 *EBRI Issue Brief* (VanDerhei, August 2013) used RSPM to analyze the Obama administration's fiscal year (FY) 2014 budget proposal to include a cap on tax-deferred retirement savings that would limit the amounts accumulated in specified retirement accounts to that necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law.
- The December 2013 *EBRI Notes* article (VanDerhei, December 2013) used RSPM to expand the analysis in the June 2013 *Issue Brief*. Rather than trying to reflect the real-world variation in DB accruals, the baseline analysis in the previous analysis used the median accrual rate in the sample (1.5 percent of final compensation per year of participation) as the stylized value for the baseline counterfactual simulations. The new research computed the actual final-average DB accrual that would be required to provide an equal amount of retirement income at age 65 as would be produced by the annuitized value of the projected sum of the 401(k) and IRA rollover balances.
- The January 2014 *EBRI Notes* article (VanDerhei, January 2014) used RSPM to model the likelihood that 401(k) participants currently ages 25–29 would have sufficient 401(k) accumulations that, when combined with Social Security benefits, could replace 60, 70 or 80 percent of their preretirement income on an inflation-adjusted basis.

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Endnotes

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[1] See Appendix A for a brief chronology of the model.

[2] VanDerhei (February 2014).

[3] Preretirement income in RSPM is determined in a manner similar to the average-indexed-monthly-earnings computation for Social Security with the following modifications:

- All earned income is included up to the age of retirement (i.e., there is no maximum taxable wage base constraint, and the calculation terminates at retirement age).
- Instead of indexing for changes in average national wages, the model indexes based on assumed, after-tax rate of return based on asset allocations that are a function of the individual's age in each year.

Percentile distributions are then established based on population statistics for each five-year age cohort.

[4] Figure 3 of VanDerhei (February 2014).

[5] Only Gen Xers are shown in this portion of the analysis given their longer future working careers until age 65.

[6] See VanDerhei, Holden, Alonso and Bass (December 2013) for the most recent results.

[7] VanDerhei, Holden, Alonso and Bass (October 2013).

[8] The proposed regulations for 401(k) plans were first introduced in November of 1981 and it took several years for many sponsors to introduce the plans. Moreover, many plans that were originally introduced as supplemental plans to existing defined benefit plans have been modified to provide more generous employer contributions at the time the defined benefit plans were frozen (VanDerhei, April 2010).

[9] See Figure 23 of Utkus and Young (2013) for recent evidence.

[10] Additional details on RSPM and the assumptions used in 2013 can be found in VanDerhei (June 2013). The financial market results are generated from stochastic annual returns with a log-normal distribution and an arithmetic mean of 8.6-percent real return for stocks and 2.6 percent real return for bonds.

[11] VanDerhei (September 2012).

[12] Although separate analysis was not performed on the middle class in the September 2012 EBRI publication, it is very likely that approximately 20 percent of those who had NOT previously been successful (under the actual default contribution rates) would be successful if the deferral rate was increased to 6 percent.

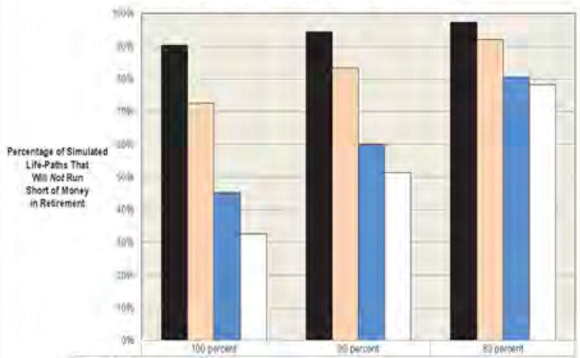
[13] VanDerhei (September 2006).

[14] EBRI is currently working on a separate study to model sequence of return risk that will need to be completed before investment risk in the decumulation period can be appropriately analyzed in RSPM.

[15] VanDerhei (August 2012).

[16] See VanDerhei (February 2014) for details.

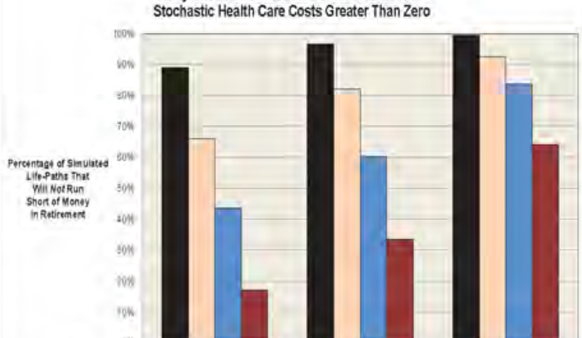
Figure 1
Impact of Relative Longevity Quartile* on 2014 Retirement Readiness Ratings,™ for Middle Class Households



	100 percent	90 percent	80 percent
Earliest Quartile	90.3%	94.5%	97.4%
Second	72.0%	83.3%	92.1%
Third	45.3%	60.2%	80.6%
Latest Quartile	32.6%	51.3%	78.3%

Source: EBRI Retirement Security Projection Model® Version 1995.
* The longevity quartile is established relative to family status, gender, and age cohort.

Figure 2
Impact of Stochastic Health Care Costs on 2014 Retirement Readiness Ratings,™ for Middle Class Households: Only Those Simulated Retirement Paths With Stochastic Health Care Costs Greater Than Zero

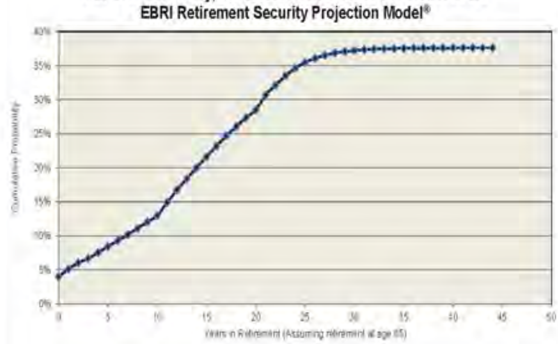


	100 percent	80 percent	60 percent
Bottom Quartile*	89.1%	96.6%	99.6%
Second	66.0%	82.0%	92.5%
Third	43.7%	60.4%	83.7%
Top Quartile	17.1%	33.6%	64.2%

Source: EBRI Retirement Security Projection Model® Version 1995
* Measured as quartile of present value at age 65 per capita stochastic health care costs in 2014 dollars

Figure 3

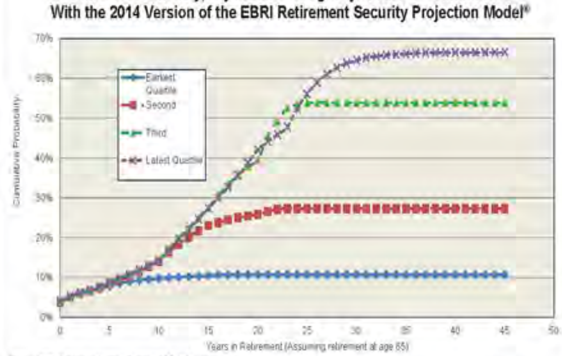
Years in Retirement Before Middle Class Boomers and GenXers Run Short of Money,* Simulations with the 2014 version of the EBRI Retirement Security Projection Model®



Source: EBRI Retirement Security Projection Model® version 2030.
* An individual or family is considered to "run short of money" in this version of the model if their aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid). The resources in retirement will consist of Social Security (either status quo or one of the specified reform alternatives), account balances from defined contribution plans, IRAs and/or cash balance plans, annuities from defined benefit plans (unless the lump-sum distribution scenario is chosen), and (in some cases) net housing equity (either in the form of an annuity or as a lump-sum distribution). This version of the model is constructed to simulate "basic" retirement income adequacy, however, alternative versions

Figure 4

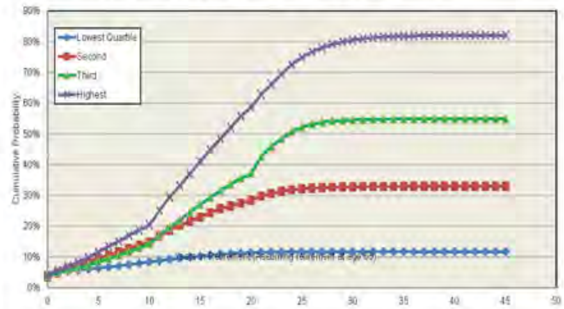
Years in Retirement Before Middle Class Boomers and GenXers Run Short of Money,* by Relative Longevity Quartile: Simulations With the 2014 Version of the EBRI Retirement Security Projection Model®**



Source: EBRI Retirement Security Projection Model® version 2030.
* An individual or family is considered to "run short of money" in this version of the model if their aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid). The resources in retirement will consist of Social Security (either status quo or one of the specified reform alternatives), account balances from defined contribution plans, IRAs and/or cash balance plans, annuities from defined benefit plans (unless the lump-sum distribution scenario is chosen), and (in some cases) net housing equity (either in the form of an annuity or as a lump-sum distribution). This version of the model is constructed to simulate "basic" retirement income adequacy, however, alternative versions of the model allow similar analysis for replacement rates, standard-of-living, and other ad hoc thresholds.
** The longevity quartile is established relative to family status, gender, and age cohort.

Figure 5

Years in Retirement Before <u>Middle Class</u> Boomers and GenXers Run Short of Money,* by Quartile of Stochastic Health Care Cost: Simulations With the 2014 Version of the EBRI Retirement Security Projection Model®



Source: EBRI Retirement Security Projection Model® version 2080.
* An individual or family is considered to "run short of money" in this version of the model if their aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid). The resources in retirement will consist of Social Security (either status quo or one of the specified reform alternatives), account balances from defined contribution plans, IRAs and/or cash balance plans, annuities from defined benefit plans (unless the lump-sum distribution scenario is chosen), and (in some cases) net housing equity (either in the form of an annuity or as a lump-sum distribution). This version of the model is constructed to simulate "basic" retirement income adequacy, however, alternative versions of the model allow similar analysis for replacement rates, standard-of-living, and other ad hoc thresholds.
** The longevity quartile is established relative to family status, gender, and age cohort.